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eurex

Eurex OTC Facilities – Maximum Flexibility for Professional Users

OTC Trades "Sponsored" by an Exchange – a Paradox?

The financial markets cater to a vast array of users, with an even larger variety of needs and preferences. This is why maximum flexibility is the key to providing efficient service. The various OTC trade entry facilities offered by Eurex have been designed to do just that: to permit professional market participants to implement complex structures and large-sized trades, based on their own individual requirements.

This article takes a closer look at exactly how OTC trades can be entered into the Eurex system, and the rules that need to be followed.

Customized Degree of Regulatory Protection

But why "go OTC" in the first place? Why can't the exchange simply relax its "crossing rules" – the regulations governing the intentional, and simultaneous entry of matching orders, and thus allow participants to trade whatever they want, at prices arranged outside the market?

The answer lies in the special role assigned to an exchange under applicable law – trading at a recognized exchange is subject to regulatory supervision, and a tight set of rules governing trading operations. Whilst this level of protection is needed to protect individual investors and retail order flows coming to the exchange, it can be an impediment to the execution of larger, more complex trading strategies. Due to their very nature, these strategies are generally negotiated directly among the parties involved. Although they are happy to remain outside the trading process of the Eurex platform, they do seek the security afforded by the clearing system.

Denying these users an appropriate "entry mechanism" to submit their off-exchange trades would, in fact, drive their volumes to the OTC market.

OTC Trades Provide a Regulated Entry Mechanism

The Eurex OTC facilities provide a controlled mechanism to enter trades that are entered into outside the exchange's trading platform, provided these trades satisfy certain conditions. For these purposes, the exchange offers three different types of OTC trade entry:

• OTC Basis Trades

Basis trades involve the exchange of cash bonds against capital market futures, trading the "basis", i.e. the valuation difference between the cash and forward markets. From the perspective of the Eurex system, this means the entry of an off-exchange futures trade, based on evidence of the corresponding cash trade.

• OTC Block Trades

Originally introduced for Eurex options, this function was expanded to include capital market futures during 2001. Block trades allow for the OTC entry of large-sized tickets into the exchange's clearing system.

• New in Release 5.0: OTC Vola Trades

The introduction of volatility ("vola") trades in February 2002 will be the latest addition to the Eurex OTC functionality. Vola trades are used to enter futures that represent the delta hedge for an existing options trade.

How do Eurex OTC Trades Work?

General Characteristics

First of all, it is important to note that Eurex OTC trades always involve contracts listed on the exchange, and do not allow for customized specifications. Also, the prices at which OTC trades are entered do not represent exchange prices – this is why these trades are clearly marked throughout the Eurex system (**B** for OTC basis trades, **O** for OTC block trades and **V** for

OTC vola trades). Besides this special marking, Eurex OTC trades "behave" just like exchange trades: they form part of the same position, can be closed out using either exchange or OTC trades, and are available for give-up.

Before using the OTC functionality, members must carefully examine the Conditions for Participation published by Eurex, and must submit the necessary paperwork (for more details, please refer to the Eurex website www.eurexchange.com). NCMs also need the approval of their respective GCM.

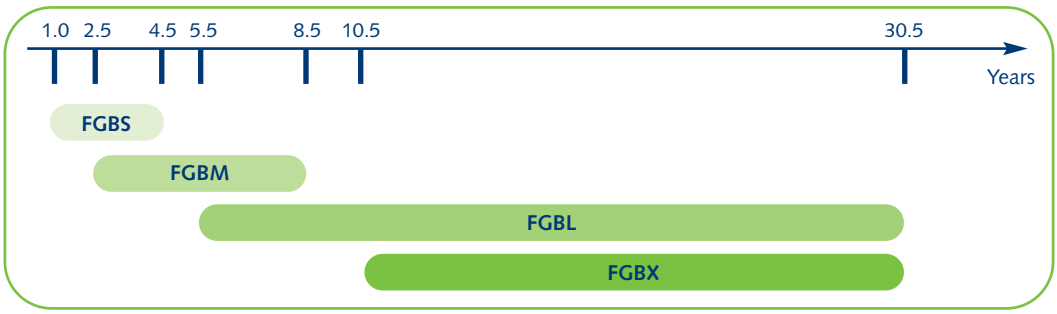
Since the Exchange's matching process is not used for OTC trades, a bilateral mechanism is required to ensure that only those trades enter the Eurex clearing system where both parties agree on all details. With all types of OTC trades, it is always the buyer of the future or option who must initiate the trade entry. Once the entry has been completed, a transaction number is assigned by the system – this number must be passed on to the seller of the derivative contract, who must use it to retrieve, check and approve the trade. Successful approval by the seller means that the trade becomes irrevocable, and is passed to the Eurex clearing process. OTC trade entries that are not approved by the end of the post-trading period of the same exchange trading day are automatically cancelled.

OTC trades do not affect the price discovery of exchange-traded products, and their prices are not broadcast. The details of OTC trades concluded are visible on the "Online Time and Sales Sheet" window on the @X-ceed GUI.

OTC Basis Trades

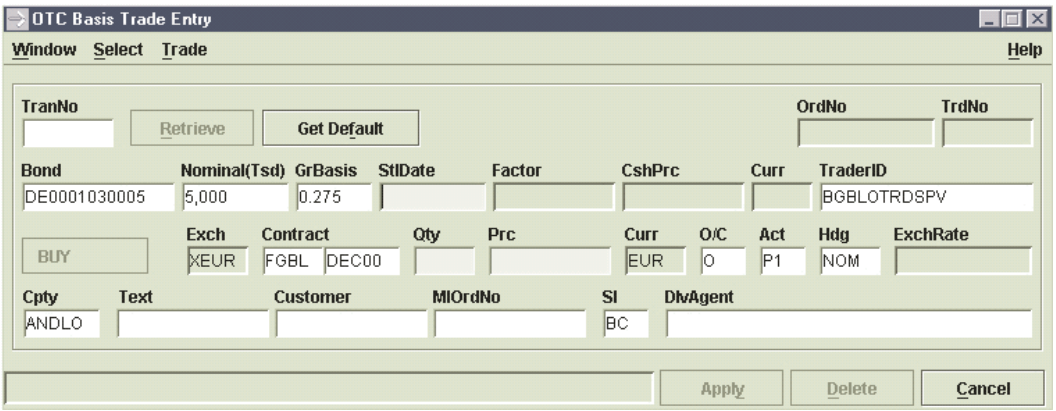
An OTC basis trade involves the simultaneous exchange of capital market futures (Euro Bund, Euro Bobl and Euro Schatz Futures) and an offsetting government bond position. This type of trade is widely used in the money market – in effect, the combination is very similar to a term deposit or term loan. The price traded is the "basis", i.e. the valuation difference between the cash bond and the futures contract. The bond does not necessarily have to be deliverable for the futures contract used; Eurex has extended the range of bonds admissible for basis trading using German government bonds:

Remaining Lifetime of Cash Bond Used for Basis Trade / Futures Products Available



This facility is also used for basis trades entered into Eurex Bonds.

The "OTC Basis Trade Entry" window is used by the buyer of futures contracts (= the seller of the basis) to enter the trade details into the system:



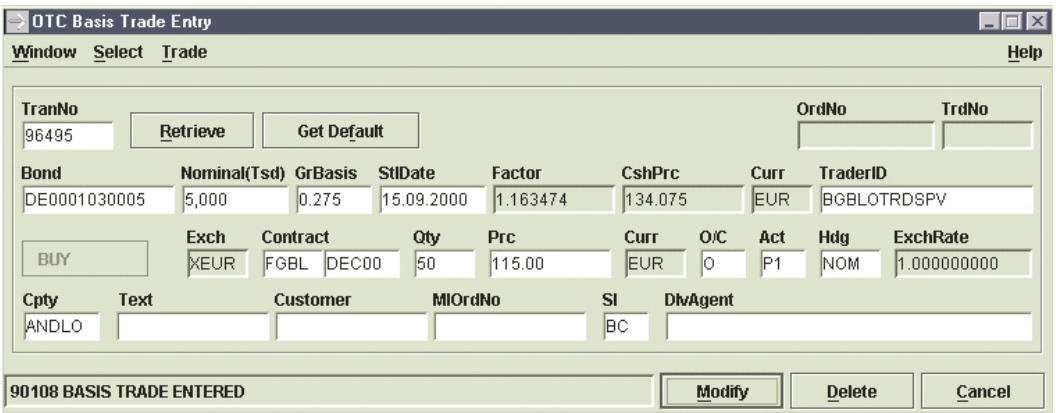
The futures buyer (= the seller of the basis) enters the main details of the basis trade.

Some points to note:

- To use the "Get Default" button, all mandatory fields (except those covered by the "Get Default" function) must have been filled, as shown in the screenshot depicted above.
- The futures price must be within the high/low range of the same exchange trading day, at the point of trade entry. Leaving the field blank, the "Get Default" button will retrieve the last traded price in the futures contract specified.
- The price for the cash bond is calculated automatically, on the basis of the futures price and basis entered.
- The number of futures contracts can be calculated using various methods (nominal values, duration, price factor, price factor CTD), and is verified by the system. Leaving the field blank, the "Get Default" button will calculate the required number of contracts.
- It is possible to enter one's own member code as the counterparty – this facilitates the entry of both sides to the trade for brokers.
- Eurex Clearing AG verifies that cash deliveries for basis trades have actually taken place.

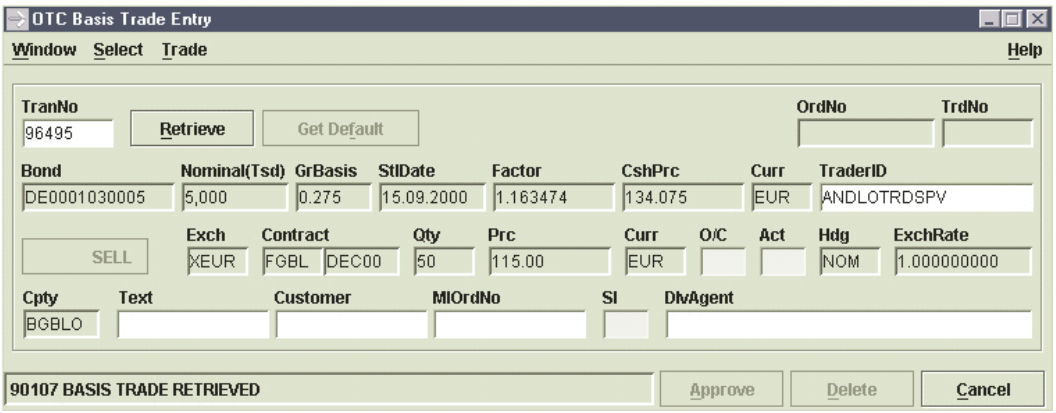
For more details, please refer to the Help function in the @X-ceed GUI, or the Trading Quick Reference Guide for Eurex Release 5.0.

Once the trade has been entered, the system assigns a transaction number:



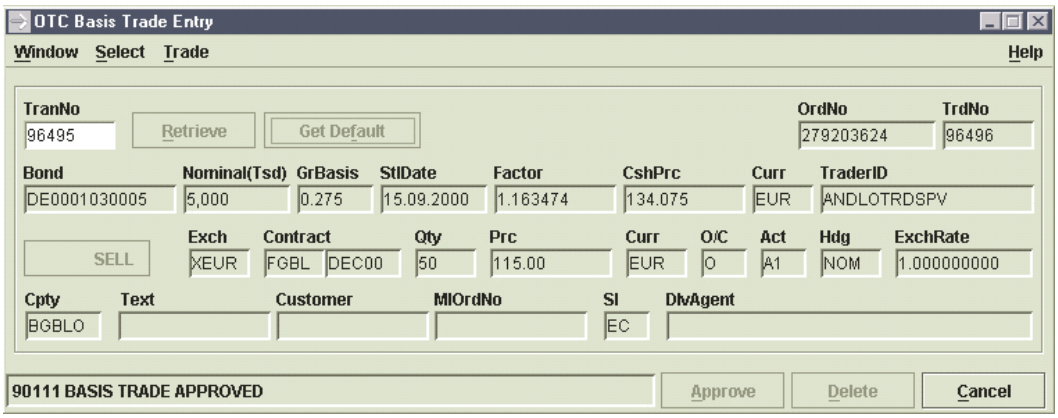
Having completed the remaining details (using "Get Default"), the futures buyer enters the trade – the system assigns the transaction number ("TranNo").

Using this number, the initiator can retrieve the trade to make amendments (provided approval has not yet taken place). The number must be passed on to the counterparty (e.g. by phone or e-mail), who can retrieve the trade for approval:



The futures seller (= the buyer of the basis) retrieves the basis trade entry (using the "TranNo").

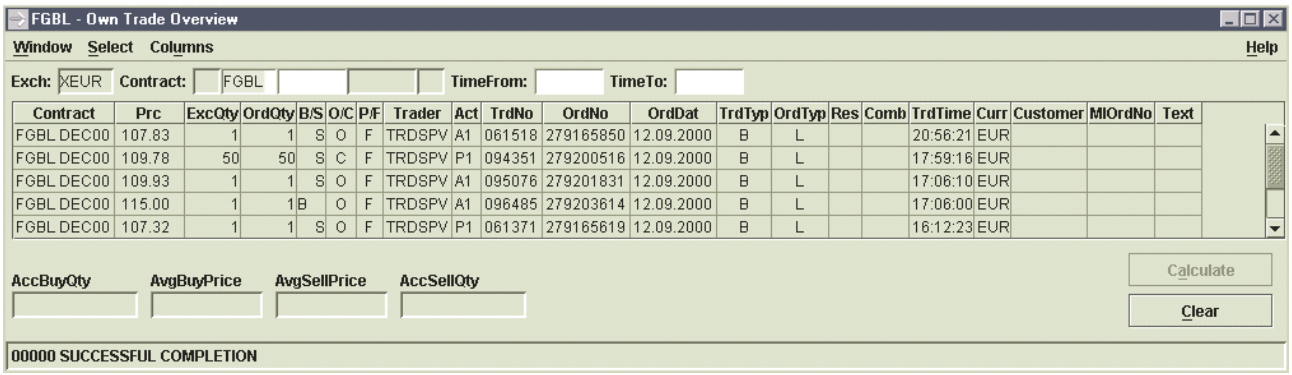
The futures seller (= the buyer of the basis) needs to check the details (note that any discrepancies must be rectified by the initiator). If all details are correct, the seller approves the trade:



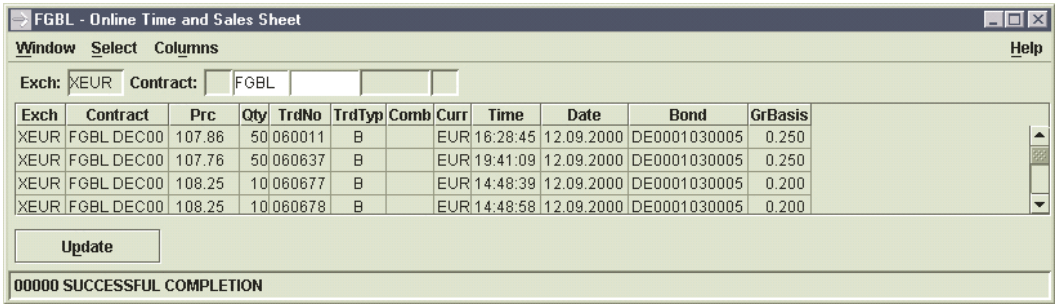
Having completed the remaining details, the futures seller approves the trade.

This approval must take place within 30 minutes of the submission of the trade; failing this, the OTC trade will be deactivated.

Following successful approval, the trade is visible in the "Own Trade Overview" window of the two parties involved…



...as well as in the "Online Time and Sales Sheet" window when filtered by trade type "B" (for the market as a whole):



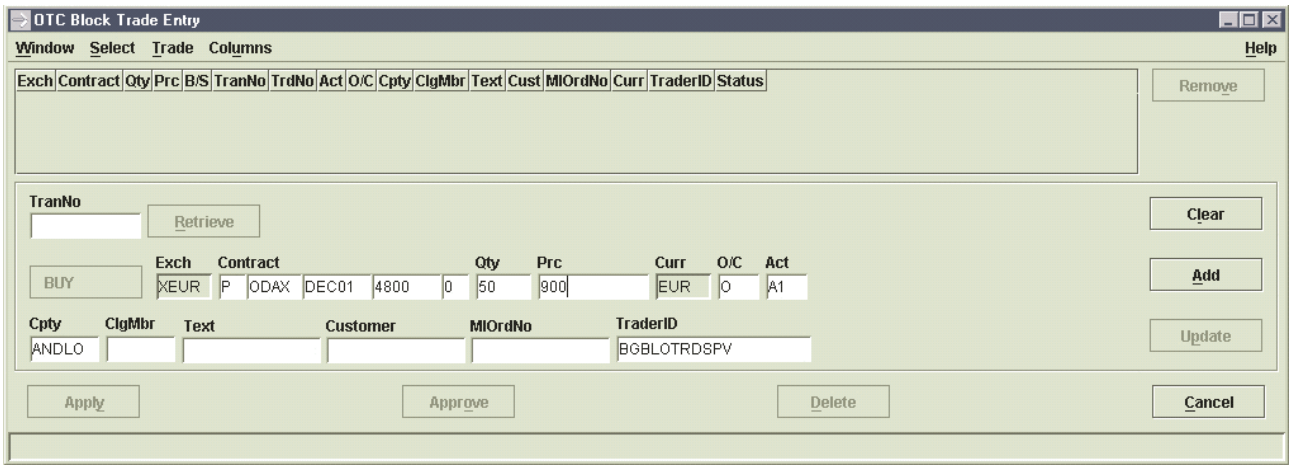
OTC Block Trades

OTC block trades facilitate the entry of large "blocks", or of multi-segment strategies that are either too complex to be executed on the exchange (e.g. "Butterfly" or "Condor" spreads), or are linked to a reference price. This allows members to establish such trades without having to go through the crossing procedure on the exchange, and avoids the associated execution risk.
Using the OTC Block Trade Facility is subject to certain minimum trade sizes:

Product	Minimum Block Trade Size (contracts)
Futures	
FEU3	100
FGBS	4,000
FGBM	3,000
FGBL	2,000
FGBX	100

Product	Minimum Block Trade Size (contracts)
Options	
OGBS, OGBM, OGBL	50
ODAX, OSMI	500
OESX	1,000
OFOX	250
Equity options (except ALV / MUV2 / SAP3)	250
ALV / MUV2 / SAP3	50

The "OTC Block Trade Entry" window is used by the buyer of futures or options contracts to enter the trade details into the system:

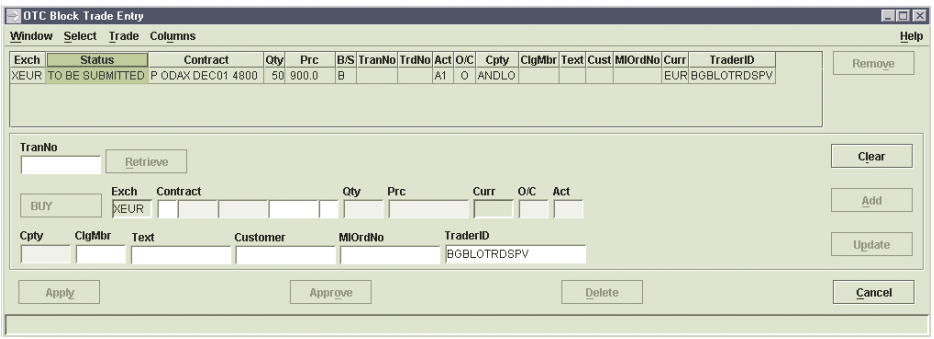


The options buyer enters the details of the block trade.

Some points to note:

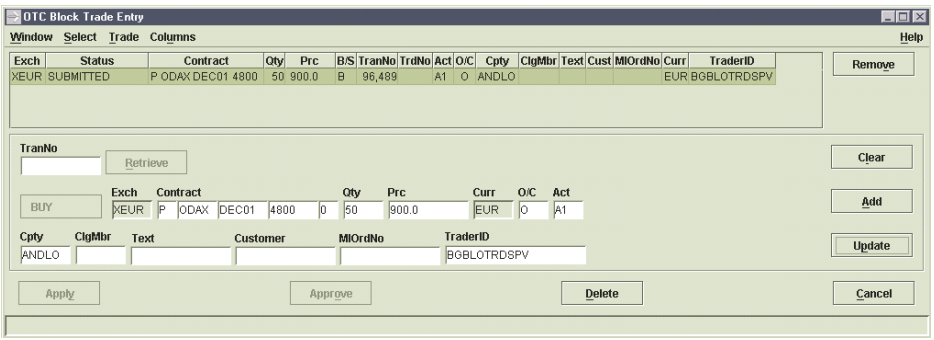
- The futures price must be within the high/low range of the same exchange trading day, at the point of trade entry. The options price must be within a range of theoretical prices determined on the basis of the current high and low of the underlying instrument.
- The "OTC Block Trade Entry" window has been designed to facilitate the multiple entry of several block trades. Details are entered in the field group, and entries added to the list box above (using "Add"). To submit these trades, they must be selected in the list box and submitted by pressing "Apply".
- It is possible to enter one's own member code as the counterparty – this facilitates the entry of both sides to the trade for brokers.

For more details, please refer to the Help function in the @X-ceed GUI, or the Trading Quick Reference Guide for Eurex Release 5.0.



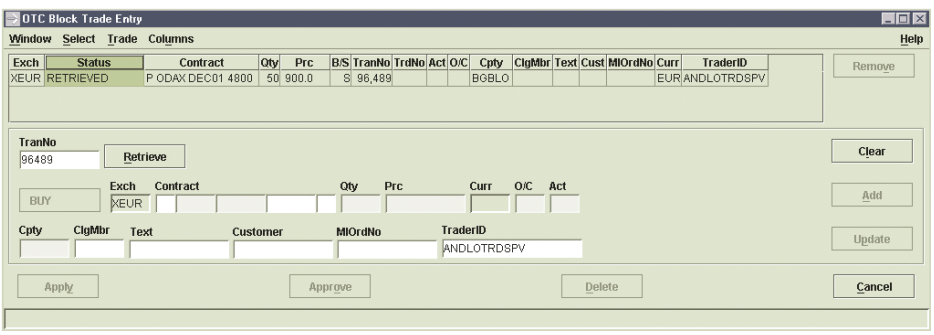
Using the "Add" button, the buyer enters the trade into the window ledger.

Once a trade has been entered, the system assigns a transaction number:

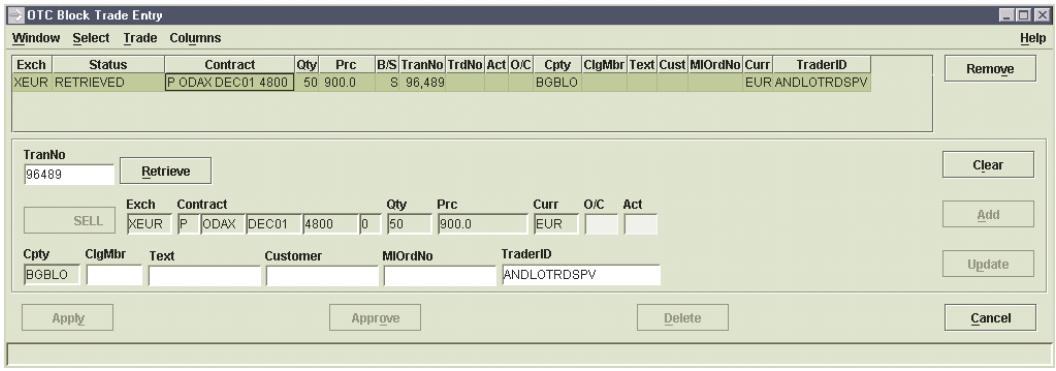


The buyer selects the trade in the list box and hits "Apply" to submit the trade.

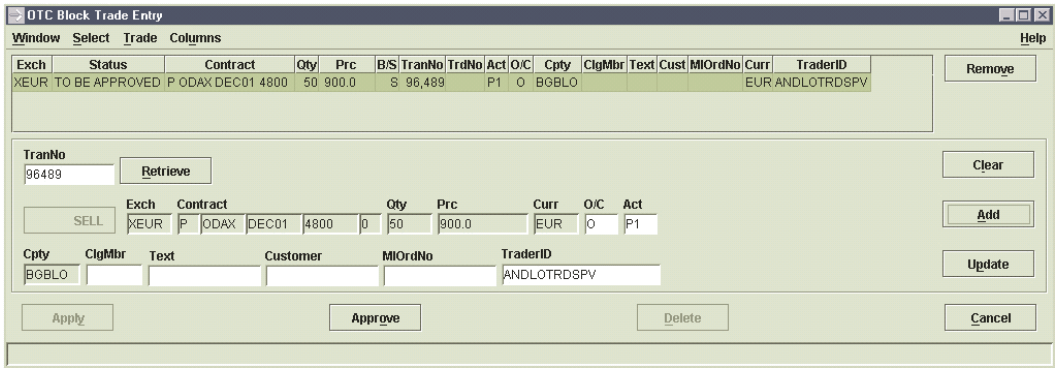
Using this number, the initiator can retrieve the trade to make amendments (provided approval has not yet taken place). The number must be passed on to the counterparty (e.g. by phone or e-mail), who can retrieve the trade for approval. The options seller needs to check the details (note that any discrepancies must be rectified by the initiator). If all details are correct, the seller approves the trade:



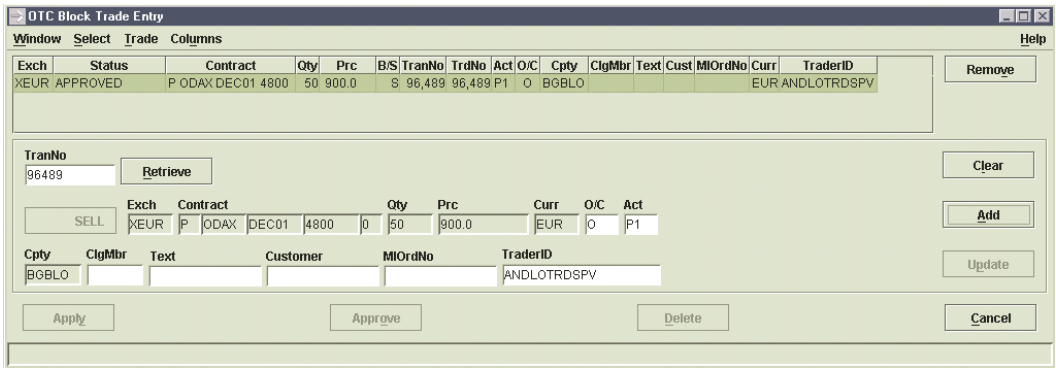
The options seller retrieves the block trade entry (using the "TranNo").



The options seller selects the trade to be approved in the list box, ...



... completes the remaining details, ...



... and approves the trade.

Following successful approval, the trade is visible in the "Own Trade Overview" window of the two parties involved, as well as in the "Online Time and Sales Sheet" window when filtered by trade type "O" (for the market as a whole).

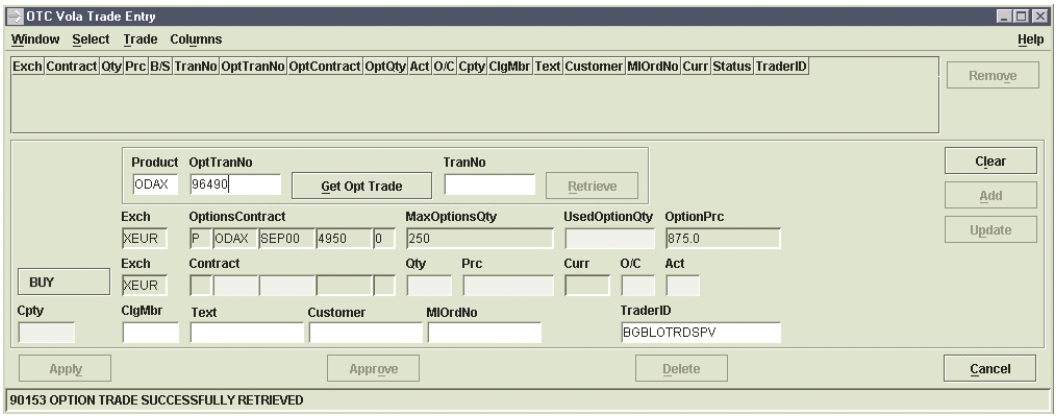
New in Eurex Release 5.0: OTC Vola Trades

The introduction of OTC vola trades in February 2002 comes in response to numerous requests from members. Whilst before, it was possible to enter into complex or large-sized options trades using the OTC Block Trade Facility, establishing the (futures) delta hedge to match such strategies represented a problem, since this required going through a crossing procedure on the exchange. In doing so, members were subject to execution risk, and could not ensure that the hedge was entered into at the reference price upon which the option strategy was based.

The OTC Vola Trade Entry Facility has solved this issue by allowing members to enter such futures positions as an OTC trade – irrespective of whether the underlying options trade was an exchange trade, or an OTC block trade. The facility is available for all Eurex options which are activated

for the Block Trade Facility. (Note that Xetra® also offers an OTC Entry Facility that can be used for delta hedges of equity options.)

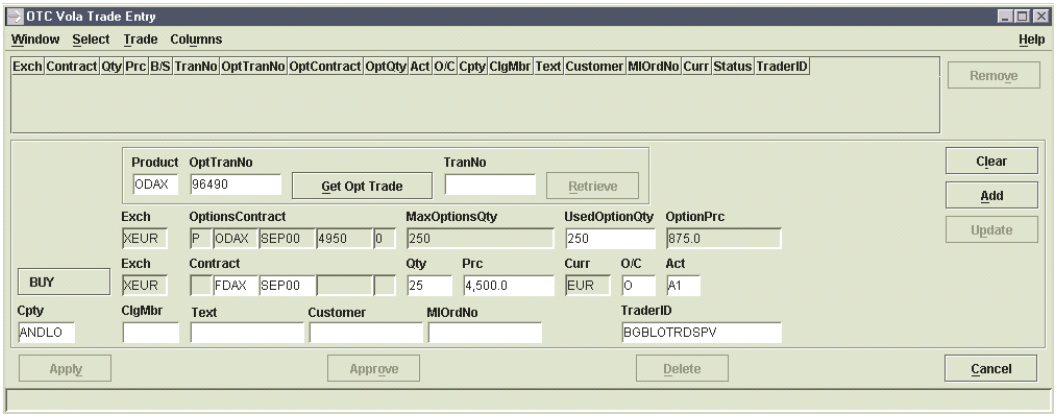
The first step to enter an OTC vola trade is to retrieve an existing options trade that must have been concluded on the same exchange trading day. To do so, the trade number of that trade must be entered into the "OptTranNo" field and the "Get Opt Trade" button pressed:



The futures buyer retrieves the option trade on which the vola trade entry is to be based.

Note that both exchange and OTC block trades are eligible as the basis of an OTC vola trade – obviously, the options trade must have been executed prior to entering the hedge (note: the identity of the counterpart has to be known).

Now the number of options contracts used as the basis of the hedge must be specified in the "Used Option Qty" field; this may be the full size of the selected options trade, or a part thereof. At the same time, the details of the futures hedge must be specified:



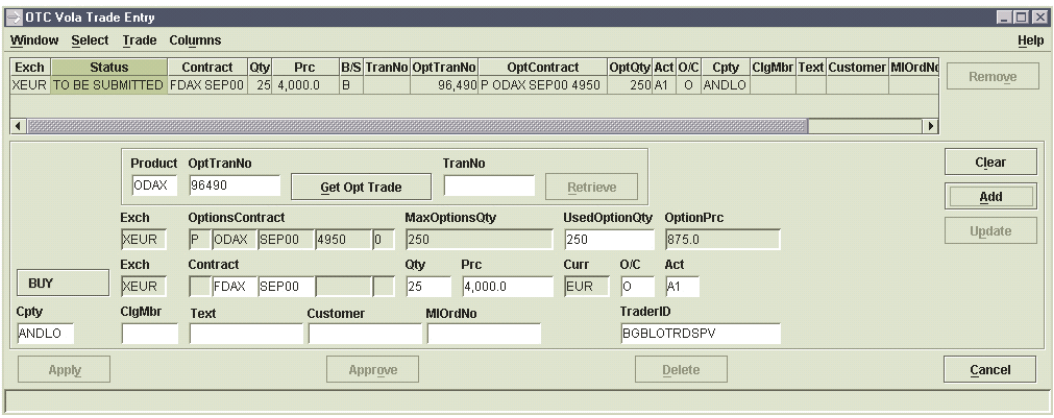
The futures buyer specifies the number of options contracts to be used for the delta hedge, and enters the details of the futures trade.

Some points to note:

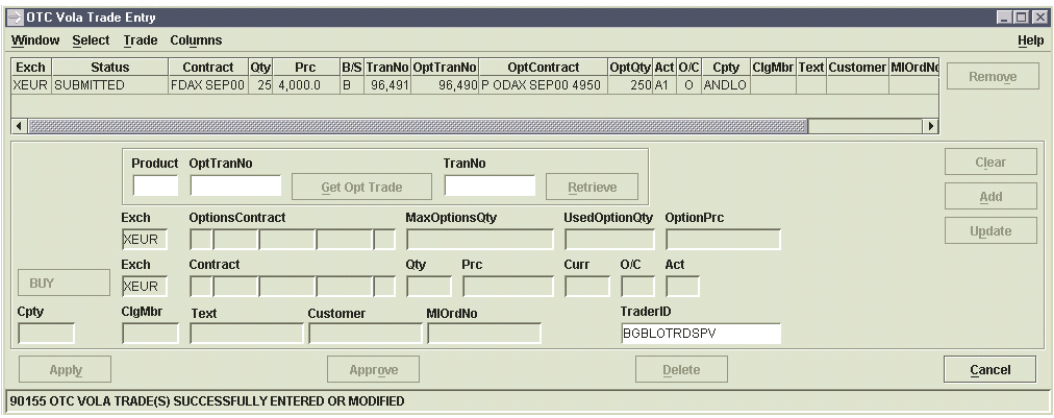
- The futures price must be within the high/low range of the same exchange trading day, at the time of trade entry.
- The hedge ratio is automatically checked by the Eurex system, on the basis of theoretical pricing parameters used to calculate the previous day's settlement prices.
- There are no minimum size restrictions for OTC vola trades – in fact, the size of the futures hedge is determined by the contract quantity of the options trade selected, and the delta factor of the option.
- It is possible to enter one's own member mnemonic as the counterparty – this facilitates the entry of both sides to the trade for brokers.

For more details, please refer to the Help function in the @X-ceed GUI, or the Trading Quick Reference Guide for Eurex Release 5.0.

Once a trade has been entered, the system assigns a transaction number:

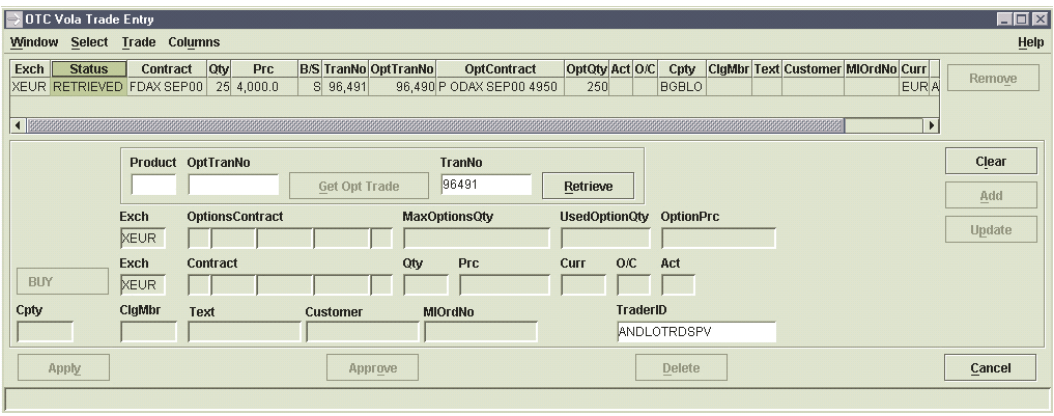


Using the "Add" button, the futures buyer enters the trade into the window ledger.

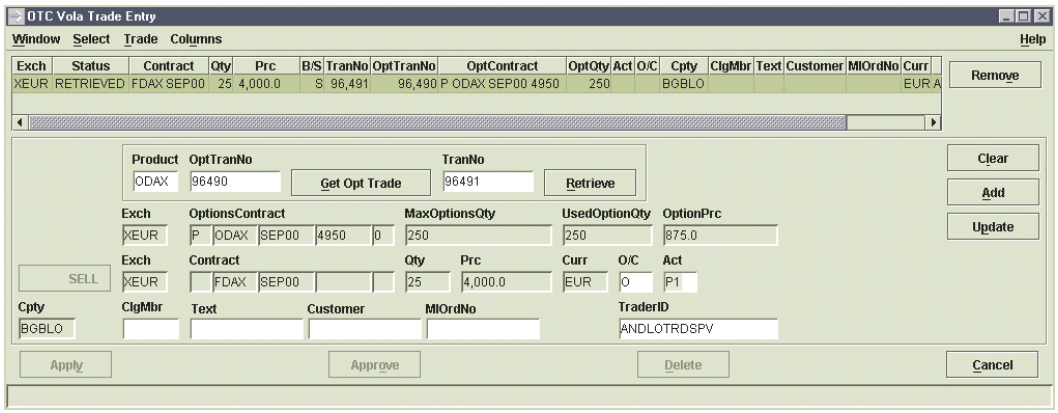


The futures buyer selects the trade in the list box and hits "Apply" to submit the trade – the system assigns the "TranNo".

Using this number, the initiator can retrieve the trade to make amendments (provided approval has not yet taken place). The number must be passed on to the counterparty (e.g. by phone or e-mail), who can retrieve the trade for approval:

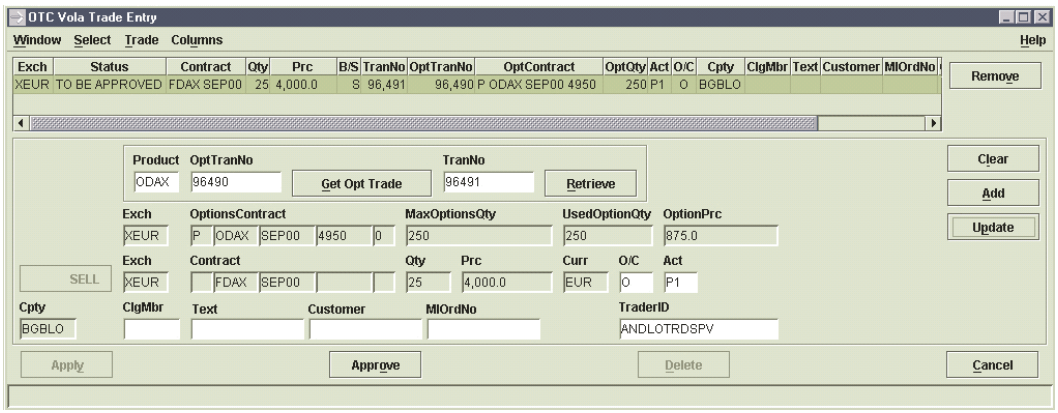


The futures seller retrieves the OTC vola trade, using the "TranNo".

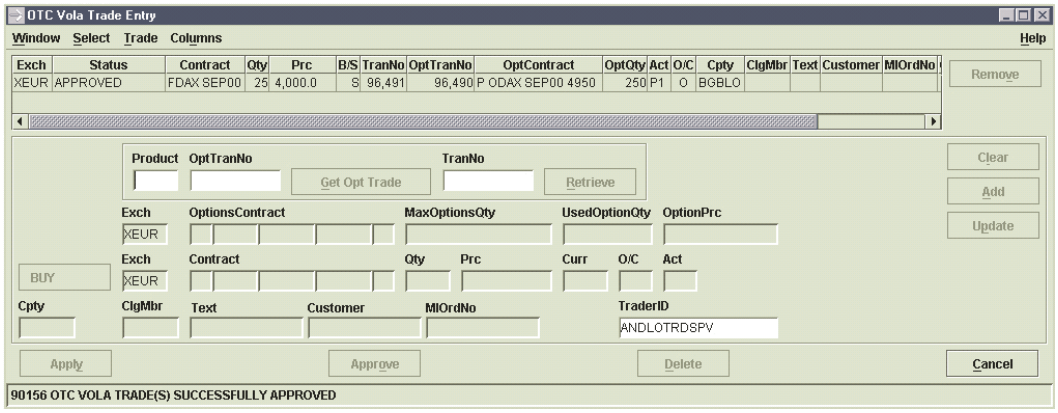


The futures seller selects the trade to be approved in the list box, ...

The futures seller needs to check the details (note that any discrepancies must be rectified by the initiator). If all details are correct, the seller approves the trade:



... completes the remaining details, ...



... and approves the trade.

Following successful approval, the trade is visible in the "Own Trade Overview" window of the two parties involved, as well as in the "Online Time and Sales Sheet" window when filtered by trade type "V" (for the market as a whole).

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