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### COMMENT

June 8, 2001

Jean A. Webb  
Secretary  
Commodity Futures Trading  
Commission  
Three Lafayette Centre  
1155 21st Street, N.W.  
Washington, D.C. 20581

Jonathan G. Katz  
Secretary  
Securities and Exchange Commission  
450 Fifth Street, N.W.  
Washington, D.C. 20549-0609

RE: "Narrow-Based Security Indexes"/"File No. S7-11-01"

Dear Sir and Madam:

This comment letter is submitted on behalf of the **Hong Kong Futures Exchange Limited ("HKFE")** a wholly-owned subsidiary of Hong Kong Exchanges and Clearing Limited, and largest regulated futures market in the Special Administrative Region of Hong Kong, China, where a total of 9,260,570 futures and options contracts were traded during the 2000 calendar year.

Since 1986 in the case of futures, and 1993 in the case of options, the HKFE has listed derivatives on Hong Kong's premiere benchmark stock index, the Hang Seng Index ("HSI"), which has a reputation within the financial community as a reliable reflection of the condition of the Hong Kong securities market operating primarily on the Stock Exchange of Hong Kong, now a sister affiliate of the HKFE.

Since 1995, the HKFE has also listed futures and option contracts on major individual Hong Kong equity securities.

The HKFE is regulated by the Securities and Futures Commission which is an active member of the International Organization of Securities Commissions as well as signatory to cooperation and information-sharing agreements with both the CFTC and the SEC.

## **PART I: The INTEREST OF THE HKFE.**

### **Why It Matters.**

Prior to the Commodity Futures Modernization Act of 2000 ("CFMA"), a determination that an index is narrow-based precluded U.S. investors from using any related domestic or foreign futures contract (interestingly, an *option* on that same index was freely tradable).

While the CFMA has modified that ban by reclassifying narrow-based stock index futures as permissible investments by U.S. persons but under a co-regulatory scheme shared by the CFTC and SEC, this relief applies only when the contract is listed on a CFTC- or SEC-regulated market. Any such product listed on a foreign board of trade remains off-limits to U.S. investors unless special steps are taken by the agencies on their behalf.<sup>1</sup>

Even if the CFTC and SEC take those steps, it is unclear whether the outcome would help U.S. investors to gain access to the foreign markets. In most cases, for example, nothing will be gained if foreign markets are told that they may only offer index futures to U.S. investors if every component stock in the index has been SEC-registered under section 12 of the Securities Exchange Act (a listing requirement being imposed on the domestic securities and futures markets); only rarely will this be the case, even in highly industrialized nations. As a result, the prospects for access by U.S. investors to stock index hedging tools on foreign boards of trade remain highly uncertain.

### **Facing the Unregulated Competition.**

The CFMA overturned 80 years of federal policy confining futures trading to the regulated exchanges. Today, a generous list of "eligible contract participants" or "ECPs" can trade narrow-based stock index futures or even single-stock futures among themselves without any contact with the regulated markets. Restrictions, conditions, and standards imposed on-market do not apply; ECPs can design their own terms and conditions without interference from either the CFTC or the SEC. It is estimated that 75%-85% of volume on the U.S. futures markets is contributed by ECPs.

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<sup>1</sup> Like its predecessor statute, the Commodity Futures Modernization Act continues as a technical matter to *prohibit* all stock index futures contracts (broad as well as narrow) and all single-stock futures contracts if they are listed on a foreign board of trade. Steps will need to be taken by the CFTC in the case of foreign broad-based stock index futures, and by both agencies jointly in the case of security futures, to lift this ban.

Were the CFTC and the SEC to impose upon the foreign boards of trade various standards for security futures, none of them would prevent ECPs from trading unqualified instruments among themselves. Under the mantle of "investor protection," this policy would impair solely the operations of the *exchanges* while business in the unqualified products could flourish among ECPs. Although the CFMA has clearly removed a four-generation advantage that exchanges had over others wishing to offer futures contracts, it could not have meant to tilt the scale so far in the opposite direction that *only* access to the regulated markets is impaired by federal regulatory policies.

In short, rules by the CFTC and SEC to govern what is offered on-exchange, whether tailored to foreign needs or not, would have little impact on the availability of impermissible instruments in the vast ECP world. For this reason, the HKFE includes at Part III a proposal to address this reality.

#### **PART II: CFTC RULE 41.13 and SEC RULE 3a55-3**

In the captioned Rules, the two agencies propose to determine that, at a minimum, a stock index futures contract listed on a foreign board of trade will not be treated as involving a "narrow-based" index if it satisfies the standards that are applied in making the same determination on a U.S. market. In that event, the contract would not be a "security futures" subject to joint CFTC/SEC regulation; the CFTC would be the sole regulator.

In PART I, we discussed why standard-setting for exchange-traded security futures is fruitless if parties accounting for a lion's share of volume on those markets may simply trade unqualified products among themselves without meaningful accountability to the CFTC or the SEC. This PART II addresses what standards would be justified if such a system could work in the first place.

The agencies acknowledge that they will need to conduct additional rulemaking in order to address whether foreign stock index futures that would be "narrow" under the statutory standards should be treated differently because of the foreign nature of the market. This issue is squarely presented by the language of the Act itself<sup>2</sup> and, in the view of the HKFE, should involve standards other than those applied to U.S. securities and futures exchanges.

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<sup>2</sup> Section 2(a)(1)(E) ("shall take into account, as appropriate, the nature and size of the markets that the securities underlying the security futures product reflects.")

*Standard Number One:*

1. The index should be demonstrably a good reflection of the performance of the stock market to which it relates.

The irony of imposing U.S.-style standards on foreign stock index futures contracts is that they would foreclose use of indexes that are remarkably faithful measures of local stock market performance.

*Standard Number Two:*

2. The futures contract should be demonstrably able to act as a hedging or risk-shifting device that is of value to both foreign and domestic investors wishing to "filter out" market-wide or systemic price events.

Many emerging and developing countries of the world remain reliant on capital infusions from wealthier nations and their investors to expand their economies, to perfect their social systems, and to set a stage for political reform. Nothing in CFTC Rule 41.13 or SEC Rule 3a55-3 would prevent such countries from attracting investments from sources outside the U.S. but could interfere *only* with capital flows from the United States. Discouraging (or even prohibiting) access by U.S. investors to a good hedging tool for their foreign investments needs to be reviewed against other American public policy designed to stimulate international economic growth.

*Standard Number Three:*

3. Quantitative standards (percentages of aggregate capitalization, average volumes, etc.), if any, must be consistent with the realities of the local stock market and economy.

In many nations, the aggregate capitalization of the stock market may fall short of the new statutory criteria; or most capitalization may be concentrated within a few constituent companies; or the stage of privatization may be too early to avoid significant cross-ownership or government-control situations; or average trading volumes may not approach the U.S. "minimums."

*Standard Number Four:*

4. Although quantitative standards have appeal because they are a convenient way to administer any program, they do not address the core issue of

whether the stock index futures contract is readily susceptible to being manipulated or to being used for the manipulation of an underlying component stock.

The application of quantitative standards regarding such features as aggregate capitalization, average daily trading volume, or relative weightings of component index stocks is completely indifferent to whether or not the stock index futures contract is actually a safe and sound instrument. In the case of HKFE, for example, the HSI futures contract has traded since 1986. During that 15-year period, approximately *45 million* HSI futures contracts have traded. There have been *no* findings of manipulation involving the HSI contract by the SFC or by any foreign regulator. This record of success is a better measure of regulatory compliance than any quantitative measure and yet, under the latter approach, is dismissed as irrelevant.

### **PART III: MAKING EXCEPTION FOR ECPs**

As noted in PART I, none of the standards that the CFTC and SEC would apply to exchange-listed security futures must be met when ECPs conduct business in the stock index instruments between themselves. They can engage in private futures transactions involving securities that are not §12 registered, or in index futures that are palpably "narrow," free in large measure from either CFTC or SEC scrutiny. As a consequence, any expectations of subjecting ECPs to the statutory or proposed security futures standards are illusory.

To maintain a competitive balance between the exchanges and the ECP environment, all that is needed is to extend to their on-exchange activity the ECPs' existing exclusion for OTC transactions in the same security futures. This exclusion should inure to the equal benefit of both domestic and foreign boards of trade and permit them to capture ECP business that would otherwise simply migrate to other venues. The proposed joint CFTC/SEC program, of course, would continue to provide investor protection for those market participants lacking the credentials of an ECP.

### **PART IV: CONCLUSION**

The CFMA continues the Shad-Johnson ban on offering security futures to U.S. investors. The CFTC and SEC are signaling a willingness to provide relief and have invited comment on what form that relief should take. Simply overlaying the CFMA standards, which are based on the statistics of the world's largest economy, would not be reasonable in a foreign context, especially if the foreign stock index futures contract is an effective hedging tool in relation to local market systemic risk and has a proven record of trouble-free performance. For instance, requiring that each underlying stock must be SEC-registered would

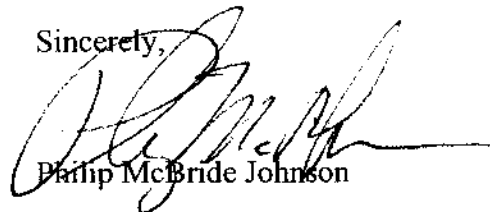
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disqualify most foreign indexes even if they are excellent risk-management devices with no history of manipulation. It could also undermine American foreign policy favoring U.S. capital investment in emerging economies.

A looming factor in this debate is the right of ECPs to make their own rules for security futures transactions conducted privately among themselves. They may trade futures on unregistered securities, for example, or on indexes containing very high concentrations of capitalization, low volume, abundant cross-ownership or government control. They can set their own margin levels and other transaction terms. Because ECPs have this choice when operating in the OTC market, the exchanges are keenly disadvantaged by being unable to offer the same flexibility to those ECPs. Therefore, the agencies should empower the domestic and foreign exchanges by agreeing, at a minimum, that security futures can be offered on-exchange to ECPs in any form that ECPs could procure them in the OTC market.

The Hong Kong Futures Exchange welcomes this opportunity to comment and stands ready for any follow-up discussion that either or both agencies may find productive.

Sincerely,



Philip McBride Johnson

cc. The Honorable Laura S. Unger  
The Honorable James E. Newsome  
The Honorable Isaac C. Hunt, Jr.  
The Honorable Barbara Pedersen Holum  
The Honorable Paul R. Carey  
The Honorable David D. Spears  
The Honorable Thomas J. Erickson