

CFTC Letter No. 00-51

April 6, 2000

No-Action

Office of General Counsel

Ms. Karen Dixon
Marketing Director
The London International Financial Futures
And Options Exchange
Cannon Bridge House
1 Cousin Lane
London EC4R 3XX
United Kingdom

Re: No-Action Request to Permit the Offer and Sale in the U.S. of Futures Contracts on the Morgan Stanley Capital International Incorporated Pan-Euro Index and the Morgan Stanley Capital International Incorporated Euro Index Traded on The London International Financial Futures and Options Exchange

Dear Ms. Dixon:

This is in response to letters and facsimiles dated from March 30, 1999, through March 10, 2000, requesting that the Office of the General Counsel of the Commodity Futures Trading Commission ("Commission" or "CFTC") issue a "no-action" letter concerning the offer and sale in the United States ("U.S.") of The London International Financial Futures and Options Exchange's ("LIFFE") futures contracts based on the Morgan Stanley Capital International Incorporated ("MSCI") Pan-Euro Index ("MSCI Pan-Euro Index") and Euro Index ("MSCI Euro Index") (collectively, "Indices").

We understand the facts to be as follows. The LIFFE is under the regulatory jurisdiction of the Financial Services Authority ("FSA"). The FSA derives its authority from, and implements and enforces the provisions of, the Financial Services Act of 1986. The Financial Services Act provides comprehensive authority for regulating the financial services industry in the United Kingdom ("U.K."), including principles for market integrity and investor protection.¹

The MSCI Pan-Euro Index and the MSCI Euro Index are broad-based, modified capitalization-weighted composite indices designed and administered by MSCI. The MSCI Pan-Euro Index includes the largest and most liquid stocks in the MSCI Europe Index² from 15 European countries.³ The MSCI Euro Index is a subset of the MSCI Pan-Euro Index and includes the largest and most liquid stocks from the 10 European

Union countries⁴ represented in the MSCI Pan-Euro Index that have entered the European Monetary Union.

Based on data supplied by LIFFE, the total market capitalizations of the MSCI Pan-Euro Index and the MSCI Euro Index were about U.S. \$6.19 trillion and \$3.59 trillion, respectively, as of December 31, 1999.⁵ Stock selection criteria ensure that only the most liquid stocks are included in the Indices. As of December 31, 1999, no single stock in the MSCI Pan-Euro Index and the MSCI Euro Index represented more than 3.58% and 6.22%, respectively, of the market capitalizations of the Indices. The five most heavily-weighted stocks in each of the Indices represented 15.34% of the market capitalization of the MSCI Pan-Euro Index and 23.39% of the MSCI Euro Index. The Indices are reviewed annually in November for index adjustments and on an on-going basis for corporate events such as new issues, mergers, acquisitions, bankruptcies, and other similar market-driven events. MSCI calculates the Indices in real time and disseminates the Indices through electronic media, such as Reuters and Bloomberg, every 15 seconds.

Futures contracts based on the Indices have traded on the LIFFE since May 25, 1999. The terms and conditions for each subject contract are identical, with the exception of the underlying index. Both contracts provide for cash settlement. The notional value for each of the contracts is determined by multiplying the relevant Index by 20 euros. Prices are quoted in Index points with each Index point equal to 20 euros per contract. Contract delivery months are the three nearest months in the March quarterly cycle, and the last trading day for the contracts is the third Friday of the month. Cash settlement occurs on the first business day after the last trading day. The final settlement price is derived from the average of the Index values calculated every 15 seconds between 12:40 p.m. and 1:00 p.m. (Central European Time) on the last trading day.⁶

The offer and sale in the U.S. of futures contracts traded on or subject to the rules of a foreign exchange is subject to the Commission's exclusive jurisdiction.⁷ Section 2(a)(1)(B)(v) of the Act, 7 U.S.C. § 2a(v) (1994), generally prohibits any person from offering or selling a futures contract based on a securities index except as permitted under Section 2(a)(1)(B)(ii), 7 U.S.C. § 2a(ii) (1994), which sets forth three criteria to govern Commission designation of futures contracts on a group or index of securities:

- (1) the contract must provide for cash settlement;
- (2) the contract must not be readily susceptible to manipulation nor to being used to manipulate any underlying security; and
- (3) the index must be predominately composed of the securities of unaffiliated issuers and reflect the market for all publicly traded securities or a substantial segment thereof.

See H.R. Rep. No. 565, Part 1, 97th Cong., 2d Sess. 39 (1982).

Section 2(a)(1)(B)(ii) also provides that the Commission shall not designate a board of trade as a contract market unless the Commission finds that the board of trade meets the criteria enumerated therein. Although

we understand that LIFFE does not seek designation as a contract market, the Committee on Agriculture of the U.S. House of Representatives ("House Committee") suggested that a foreign board of trade like LIFFE could apply to the Commission for "certification" that its stock index contract conforms with the requirements of the Act established for a specifically identified contract and therefore could be offered and sold in the U.S. See H.R. Rep. No. 565, Part 1, 97th Cong., 2d Sess. 85 (1982). The House Committee explained, for example, that a foreign exchange could seek certification from the Commission that its futures contract based upon an index of U.S. securities meets the requirements set forth in Section 2(a)(1)(B)(ii). Id.

As noted above, we understand that the securities in the Indices are issued by European companies only. With respect to futures contracts based on such foreign securities indices, the House Committee suggested that the Commission may use such criteria as it deems appropriate to determine whether such futures contracts may be offered and sold in the U.S. Id. In this regard, the requirements of Section 2(a)(1)(B)(ii) of the Act were designed to permit futures trading in "broad-based . . . indices that are not conducive to manipulation or disruption of the market for the underlying securities." S. Rep. No. 390, 97th Cong., 2d Sess. 6 (1982). See also H.R. Rep. No. 565, Part 1, 97th Cong., 2d Sess. at 39. Accordingly, we have examined LIFFE's futures contracts on the MSCI Pan-Euro Index and the MSCI Euro Index in light of these criteria. Based on the information noted herein and as set forth in the letters, attachments and facsimiles noted above, we have determined that these futures contracts conform to these requirements.

In evaluating whether a foreign futures contract based on a foreign stock index is not readily susceptible to manipulation or to being used to manipulate any underlying security, this Office inquires whether surveillance-sharing arrangements exist between the requesting futures exchange and the securities exchanges which are the home securities exchanges for the stocks underlying the index. The MSCI Pan-Euro Index and the MSCI Euro Index contain stocks that are traded on securities exchanges in 15 and 10 European countries, respectively. LIFFE has exchange-to-exchange surveillance-sharing agreements with the securities exchanges in two countries, the U.K. and the Netherlands. Both the U.K. and the Netherlands are represented in the MSCI Pan-Euro Index, and the Netherlands is represented in the MSCI Euro Index. In the U.K., LIFFE has signed a regulatory agreement with the London Stock Exchange ("LSE") that provides for the exchange of information regarding the MSCI Pan-Euro Index futures contract and component stocks of that Index traded on the LSE.⁸ Moreover, in the Netherlands, LIFFE has entered into an information-sharing agreement with the Amsterdam Exchanges for the exchange of information regarding stocks on both Indices.⁹ The component stocks covered by these exchange-to-exchange surveillance-sharing agreements represent 37.14% of the market capitalization of the MSCI Pan-Euro Index and 14.23% of the MSCI Euro Index.

In addition, the U.K., as a member of the European Union, is subject to the Investment Services Directive ("ISD"), which sets out the legal basis for the provision of investment services throughout the European Union. The ISD has been implemented into national law by all member countries. In the U.K., the FSA is the main competent authority for the ISD's purposes. All of the countries that have stock represented in the MSCI Euro Index are subject to the ISD. With respect to the MSCI Pan-Euro Index, all of the countries represented are subject to the ISD except Switzerland.¹⁰ Stocks traded on the securities exchanges in these countries represent 91.51% of the value of the MSCI Pan-Euro Index.¹¹ LIFFE has represented that the

ISD provides a statutory framework for a comprehensive system of cooperation and information sharing among authorities that are responsible for regulating financial services within the European Union.¹² Moreover, LIFFE has represented that through the ISD it can receive information about market trading, clearing activity and customer identity.¹³

In consideration of LIFFE's exchange-to-exchange surveillance-sharing agreements and the various bilateral and multilateral information-sharing arrangements to which the U.K. is a party, as noted herein, we have concluded that LIFFE will have sufficient access to the information it may need to detect and deter manipulation. In making this determination, we have considered the diversification, capitalization, and the liquidity of the component securities of the Indices. Nevertheless, this Office continues to advocate that exchange-to-exchange surveillance-sharing arrangements are preferable as the most expedient means to obtain the detailed information required for an effective surveillance program to detect manipulation. Therefore, we encourage LIFFE to pursue forging exchange-to-exchange surveillance-sharing agreements for the stocks underlying the Indices. In the event that LIFFE is unable to obtain access to adequate surveillance data under the means that it has cited, this Office reserves the right to reconsider the position we have taken herein.¹⁴

In light of the foregoing, the Office of the General Counsel will not recommend any enforcement action to the Commission based on Sections 2(a)(1)(B)(v), 4(a), or 12(e) of the Commodity Exchange Act, as amended, if the MSCI Pan-Euro Index futures contract and the MSCI Euro Index futures contract traded on LIFFE are offered and sold in the U.S.¹⁵ Because this position is based upon facts and representations contained in the letters, attachments and facsimiles cited above, it should be noted that any different, omitted or changed facts or conditions might require a different conclusion. This position also is contingent on the continued compliance by LIFFE with all regulatory requirements imposed by the FSA and the applicable laws and regulations of the U.K.

The offer and sale in the U.S. of LIFFE's MSCI Pan-Euro Index and MSCI Euro Index futures contracts is, of course, subject to the Part 30 regulations adopted by the Commission to govern the offer and sale of foreign futures and foreign option contracts in the U.S.¹⁶

Yours
truly,

David
R.
Merrill
Deputy
General
Counsel

cc: Ms. Annette L. Nazareth, Director
Division of Market Regulation

Securities and Exchange Commission

Michael M. Philipp, Esq.
Katten, Muchin and Zavis

1 In addition, the United Kingdom's Department of Trade and Industry and the Serious Fraud Office also play a role in preventing market manipulation and fraud. The Commission staff recently discussed the regulatory structure in the United Kingdom and the regulation of LIFFE and its members in connection with the relief granted to LIFFE to make available its electronic trading system in the United States. See CFTC Staff Letter No. 99-34, [1998-1999 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 27,744 (July 23, 1999).

2 The MSCI Europe Index is a modified capitalization-weighted index that consists of 547 securities from 15 European countries as of January 18, 2000. See letter from Karen Dixon, Market Director, LIFFE, to David R. Merrill, Deputy General Counsel, CFTC, dated February 11, 2000.

3 Countries represented in the MSCI Pan-Euro Index include Austria, Belgium, Denmark, Finland, France, Germany, Ireland, Italy, the Netherlands, Norway, Portugal, Spain, Sweden, Switzerland and the U.K.

4 Countries represented in the MSCI Euro Index include Austria, Belgium, Finland, France, Germany, Ireland, Italy, the Netherlands, Portugal and Spain.

5 See letter from Ms. Dixon to Mr. Merrill, dated March 10, 2000.

6 Of the 81 measured values, the highest 12 and the lowest 12 are discarded, and the remaining 57 are averaged to calculate the settlement price.

7 The terms "any other board of trade, exchange, or market" in Section 2(a)(1)(A)(i) make clear the Commission's exclusive jurisdiction includes futures contracts executed on a foreign board of trade, exchange or market. Section 2(a)(1)(A), 7 U.S.C. § 2 (1994); 120 Cong. Rec. 34497 (1974) (statement of Senator Talmadge).

8 See facsimile from Martyn Wild, Equity Product Development, LIFFE, to Harold Hardman, Assistant General Counsel, CFTC, dated May 20, 1999.

9 See letter from Ms. Dixon to Mr. Merrill, dated February 11, 2000.

10 The U.K. has entered into a bilateral memorandum of understanding with Switzerland. Although Norway, like Switzerland, is not a member of the European Union, it is a member of the European Economic Area and LIFFE represents that by virtue of this membership, Norway has adopted the ISD. See letter from David Wenman, Managing Director (Development), LIFFE, to Mr. Hardman, dated March 30, 1999.

11 The FSA also is a member of the Forum of European Securities Commissions ("FESCO"). The members of FESCO have entered into a Multilateral Memorandum of Understanding on the Exchange of Information and Surveillance of Securities Activities, dated January 26, 1999 ("Multilateral MOU"). Regulatory authorities in all of the countries represented in the Indices, except Switzerland, are parties to the Multilateral MOU.

12 See letter from Mr. Wenman to Mr. Hardman, dated March 30, 1999.

13 See letters from Mark Ibbotson, Director, Market Services, LIFFE, to Sharon Lawson, Senior Special Counsel, Securities and Exchange Commission ("SEC"), dated August 31, 1999 and from Laurence Walton, Senior Associate, Market Secretariat, LIFFE, to Ms. Lawson dated October 1, 1999. Specifically, in the August 31 letter LIFFE represents that the effect of the ISD is to require by law information sharing within and between relevant organizations in the European Economic Area member states. This sharing of information encompasses the basic information that would be included in a comprehensive information-sharing agreement. Through the ISD, LIFFE represents that the FSA would be able to obtain and share such information. Further, gateways in the ISD and United Kingdom law enable the FSA to pass to LIFFE information received pursuant to the ISD.

14 On September 25, 1991, a Memorandum of Understanding ("MOU") was entered into by the U.K. Department of Trade and Industry and Securities Investment Board ("SIB") and the U.S. CFTC and SEC with respect to the sharing of confidential information among agencies and mutual assistance in investigation and enforcement matters. Also, the CFTC has granted Regulation 30.10 relief to SIB, the FSA's predecessor. See Appendix C to Commission Regulation 30.10, 17 C.F.R. § 30.10. FSA also is a signatory to the Declaration on Cooperation and Supervision of International Futures Exchanges and Clearing Organizations, as amended, signed on March 15, 1996, at Boca Raton, Florida.

15 The staff of the SEC has informed us that they would have no objection to the offer and sale of the MSCI Pan-Euro Index and the MSCI Euro Index futures contracts traded on LIFFE to U.S. persons. See letter from Belinda Blaine, Associate Director, Division of Market Regulation, SEC, to C. Robert Paul, General Counsel, CFTC, dated March 30, 2000.

16 See 17 C.F.R. Part 30.