

CFTC Letter No. 01-45
May 23, 2001
No-Action
Office of General Counsel

Jane Kang Thorpe, Esq.
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1666 K Street, N.W.
Washington, D.C. 20006-1208

Re: No-Action Request to Permit the Offer and Sale in the United States of the Futures Contract on the S&P/TOPIX 150 Index Traded on the Tokyo Stock Exchange

Dear Ms. Thorpe:

This is in response to your letters, attachments, facsimiles, and e-mails dated from November 1, 2000 to May 11, 2001, requesting that the Office of 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 futures contract based on the S&P/TOPIX 150 Index ("S&P/TOPIX 150" or "Index") traded on the Tokyo Stock Exchange ("TSE").

From the above-noted submissions, we understand the facts to be as follows. The TSE is a licensed stock exchange, authorized to trade stocks, bonds, fixed income derivative products, and equity derivative products. The equity derivative products authorized for trading include futures and options on stock indices and options on equities. The TSE is regulated by the Financial Services Agency ("FSA").^[1] The FSA was established in July 2000 and results from the merger of the Financial Supervisory Agency and the Financial System Planning Bureau of the Ministry of Finance. The FSA has broad supervisory responsibility for all aspects of financial services, including inspection, supervision, and surveillance of financial activities.

The S&P/TOPIX 150 is a broad-based, modified capitalization-weighted index, derived from over 1,400 stocks that comprise the TOPIX universe, a composite index of all the common stocks listed on the First Section of the TSE.^[2] The 150 stocks in the S&P/TOPIX 150 are highly liquid securities selected from each major sector of the Tokyo market and represent approximately 70% of the market value of the Japanese equity market. Based on data supplied by the TSE, the total market capitalization of the S&P/TOPIX 150 was approximately \$1.394 trillion as of April 27, 2001. The S&P/TOPIX 150 is maintained by Standard & Poor's, in collaboration with the TSE. As of April 27, 2001, no single stock in the Index represented more than 5.96% of the Index, and the five most heavily-weighted stocks in the Index represented

21.89% of the Index.^[3] The stocks comprising the lowest 25% of the Index had a six-month average daily trading volume of approximately \$1.43 billion. The Index is calculated in real time and is disseminated through electronic means to Bloomberg and other data vendors.

The TSE's futures contract on the S&P/TOPIX 150 provides for cash settlement. The notional value for the contract is determined by multiplying the Index by 1,000 Japanese Yen. Contract delivery months are the three nearest months in the March quarterly cycle. The last trading day for the contract is the business day prior to the second Friday of the expiration month. Contracts must be cash settled by the second business day after the last trading day based on the final settlement price of the S&P/TOPIX 150. The final settlement price is based on the first contract price for S&P/TOPIX 150 constituent stocks on the business day following the last trading day.

The Commodity Exchange Act ("CEA"),^[4] as amended by the Commodity Futures Modernization Act of 2000 ("CFMA"),^[5] provides that the offer or sale in the United States of futures contracts based on a group or index of securities, including those contracts traded on or subject to the rules of a foreign board of trade, is subject to the Commission's exclusive jurisdiction,^[6] with the exception of security futures products,^[7] over which the Commission shares jurisdiction with the Securities and Exchange Commission ("SEC").^[8] Thus, the Commission's jurisdiction remains exclusive with regard to futures contracts on a group or index of securities that are broad-based pursuant to CEA Section 1a(25).^[9]

CEA Section 2(a)(1)(C)(iv) generally prohibits any person from offering or selling a futures contract based on a securities index in the United States, except as permitted under CEA Section 2(a)(1)(C)(ii) or CEA Section 2(a)(1)(D).^[10] By its terms, CEA Section 2(a)(1)(C)(iv) applies to futures contracts on securities indices traded on both domestic and foreign boards of trade. CEA Section 2(a)(1)(C)(ii) sets forth three criteria to govern Commission designation of boards of trade as contract markets and registration of derivatives transaction execution facilities ("DTF") to trade 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 group or index of securities must not constitute a narrow-based securities index.^[11]

While Section 2(a)(1)(C)(ii) provides that no board of trade shall be designated as a contract market (or registered as a DTF) with respect to stock index futures contracts unless it meets the three criteria noted above, it does not explicitly address the standards to be applied to foreign stock index futures contracts traded on foreign boards of trade. This Office has decided

to apply those same three criteria in evaluating requests by foreign boards of trade to allow the offer and sale within the United States of their foreign stock index futures contracts when those foreign boards of trade do not seek designation as a contract market or registration as a DTF to trade those products.

Accordingly, this Office has examined the S&P/TOPIX 150 and the futures contract based thereon to determine whether the Index and the futures contract meet the requirements enumerated in CEA Section 2(a)(1)(C)(ii). Based on the information noted herein and as set forth in the letters, attachments, facsimiles, and e-mails noted above, we have determined that the S&P/TOPIX 150 and the TSE's futures contract based thereon conform to these requirements.^[12]

In determining whether a foreign futures contract based on a foreign stock index is not readily susceptible to manipulation or being used to manipulate any underlying security, one preliminary consideration is the requesting exchange's ability to access information regarding the stocks underlying the index. As noted above, both the futures contract and the stocks underlying the S&P/TOPIX 150 are traded on the TSE. Thus, TSE should have access to information necessary to detect or deter manipulation. In the event that TSE is unable to obtain access to adequate surveillance data in this regard, or is unable to share such data with the CFTC, this Office reserves the right to reconsider the position we have taken herein.^[13]

In light of the foregoing, the Office of General Counsel will not recommend any enforcement action to the Commission based on Sections 2(a)(1)(C)(iv), 4(a), or 12(e) of the CEA, as amended, if the S&P/TOPIX 150 futures contract traded on the TSE is offered and sold in the U.S. Because this position is based upon facts and representations contained in the letters, attachments, facsimiles, and e-mails 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 TSE with all regulatory requirements imposed by the FSA and the applicable laws and regulations of Japan. In addition, this position may be affected by any rules that the Commission or SEC may adopt regarding futures contracts based on securities indices.

The offer and sale in the U.S. of TSE's S&P/TOPIX 150 futures contract is, of course, subject to Part 30 of the Commission's regulations which govern the offer and sale of foreign futures and foreign option contracts in the U.S.^[14]

Sincerely,

David R. Merrill
Deputy General
Counsel

[1] The Prime Minister of Japan is empowered to regulate Japanese stock exchanges. Among other things, the Prime Minister is authorized to grant licenses to stock exchanges, to approve their Constitutions, Business Regulations, and Brokerage Standards, and to approve futures contracts on stock indices. The Prime Minister, in turn, has delegated the aforementioned powers, other than the authority to grant licenses to stock exchanges, to the Commissioner of FSA. See letter from Jane Kang Thorpe, Sidley Austin Brown & Wood, to David R. Merrill, Deputy General Counsel, CFTC, dated May 11, 2001.

[2] This Office previously issued a no-action letter to the TSE for its futures contract on the TOPIX Index. See CFTC Letter No. 92-2, [1990-92 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 25,210 (January 16, 1992).

[3] The Index is weighted in terms of each constituent stock's market capitalization, adjusted to exclude the value of shares held by governments, corporations, strategic partners, or other control groups, in order to ensure that the Index represents equity that exists for investors to access.

[4] 7 U.S.C. § 1 *et seq.*

[5] Appendix E of Pub. L. 106-554, 114 Stat. 2763 (2000).

[6] See CEA Section 2(a)(1)(C)(ii).

[7] Security futures products are defined as a security future or any put, call, straddle, option, or privilege on any security future. See CEA Section 1a(32). A security future is defined as 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, with certain exceptions. See CEA Section 1a(31).

[8] See CEA Section 2(a)(1)(D).

[9] See CEA Section 2(a)(1)(C)(ii).

[10] Section 2(a)(1)(D) governs the offer and sale of security futures products.

[11] The first two criteria under CEA Section 2(a)(1)(C)(ii) were unchanged by the CFMA. With regard to the third criterion, an index is a "narrow-based security index" under both the CEA

and the Securities Exchange Act (“SEA”), 15 U.S.C. § 78a *et seq.*, if it has any one of the following four characteristics: (1) it has nine or fewer component securities; (2) any one of its component securities comprises more than 30% of its weighting; (3) the five highest weighted component securities in the aggregate comprise more than 60% of the index’s weighting; or (4) the lowest weighted component securities comprising, in the aggregate, 25% 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). See CEA Section 1a(25)(A)(i)-(iv); SEA Section 3(a)(55)(B)(i)-(iv). See *also* CEA Section 1a(25)(B); SEA Section 3(a)(55)(C). Thus, an index that does not have any of these elements is not a narrow-based security index for purposes of CEA Section 2(a)(1)(C)(ii).

[12] In making this determination, the staff has concluded that the S&P/TOPIX 150 does not have any of the elements of a narrow-based security index as enumerated in CEA Section 1a(25)(A).

[13] Consistent with its representation in connection with the issuance of the no-action letter regarding the TSE’s TOPIX futures contract, the TSE represents that it will cooperate with Commission requests for information regarding the S&P/TOPIX 150 Index and the TSE’s futures contract based thereon. See letter from Ms. Thorpe to Mr. Merrill, dated May 11, 2001. The TSE on June 22, 2000 became an affiliate member of the Intermarket Surveillance Group (“ISG”), which is comprised of representatives from U.S. and non-US securities and futures exchanges with observers from the SEC and CFTC. The members of ISG have agreed to share information to ensure coordinated surveillance of intermarket trading abuses. In addition, the TSE is a signatory to the International Information Sharing Memorandum of Understanding signed on March 15, 1996 at Boca Raton, Florida.

[14] See 17 C.F.R. Part 30.