

CFTC letter No. 03-06
February 13, 2003
No-Action
Office of General Counsel

Re: Osaka Securities Exchange's Request for No-Action Relief in Connection with the Offer and Sale of its Futures Contracts Based on the FTSE Japan Index and the MSCI Japan Index in the United States

Dear Mr. Felsenthal:

This is in response to letters, attachments, facsimiles and electronic mail dated from July 2, 2002 to January 13, 2003, requesting on behalf of your client, the Osaka Securities Exchange ("OSE"), that the Office of General Counsel ("Office") 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 OSE's futures contracts based on the FTSE Japan Index ("FTSE Japan") and the MSCI Japan Index ("MSCI Japan") (collectively, "Indices").

We understand the facts to be as follows. OSE currently is the largest equity derivatives exchange in Japan measured by trading volume and contract values.^[1] The OSE is an incorporated organization established in accordance with Japan's Securities and Exchange Law (Law No. 25 of 1948, as amended) ("Securities and Exchange Law"). The OSE is licensed to act as a stock exchange by the Prime Minister of Japan pursuant to a license initially granted by the Minister of Finance of Japan under the Securities and Exchange Law. As a licensed stock exchange, the OSE is authorized to trade stocks, bonds and equity derivatives products. The equity derivatives products authorized for trading include futures and options on security indices and options on equities.^[2]

Under the Securities and Exchange Law, the Prime Minister has supervisory authority over all stock exchanges in Japan. Among other things, the Prime Minister is authorized to grant licenses to stock exchanges, to approve their Articles of Incorporation, Business Regulations, and Brokerage Agreement Standards, and to approve futures contracts on security indices. The Prime Minister, in turn, has delegated these powers, other than the authority to grant licenses to stock exchanges, to the Commissioner of the Financial Services Agency of Japan ("FSA"). The FSA was established in July 2000 and results from the merger of the Financial Supervisory Agency and 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.^[3]

The FTSE Japan is a broad-based, modified capitalization-weighted composite security index. Maintained by FTSE International Limited, the FTSE Japan is derived from over 2,200 common stocks listed on the OSE and the Tokyo Stock Exchange ("TSE"). The 330 stocks currently in the FTSE Japan, 10 of which are listed on the OSE First Section and 320 of which are listed on the TSE First and Second Sections, represent approximately 80% of the market value of the Japanese equity markets. Based on

data supplied by OSE, the total free-float adjusted market capitalization of the FTSE Japan was U.S. \$1.335 trillion as of May 14, 2002.^[4] As of that date, the largest single stock by weight represented 5.70%, and the five most heavily weighted stocks represented 17.68%, of the adjusted market capitalization of the FTSE Japan.^[5] The stocks comprising the lowest 25% of the FTSE Japan had a six-month aggregate dollar value of average daily trading volume in excess of U.S. \$30 million: approximately U.S. \$1.284 billion for the 6-month period ending March 2002.^[6] The FTSE Japan is calculated in real time and is disseminated by electronic means through major data vendors.^[7]

The MSCI Japan also is a broad-based modified capitalization-weighted composite security index. Maintained by Morgan Stanley Capital International Inc., the MSCI Japan is derived from approximately 3,300 common stocks listed on all stock exchanges in Japan: Tokyo, Nagoya, Fukuoka, Sapporo, and Osaka. The 321 stocks currently in the MSCI Japan, 13 of which are listed on the OSE First Section, 1 of which is listed on the Nagoya Stock Exchange (“NSE”) First Section and 307 of which are listed on the TSE First Section, represent approximately 80% of the market value of the Japanese equity markets.^[8] Based on data supplied by OSE, the MSCI Japan had a total free-float adjusted market capitalization of \$1.349 trillion as of March 29, 2002.^[9] As of that date, the largest single stock by weight represented 5.96%, and the five most heavily weighted stocks represented 16.36%, of the adjusted market capitalization of the MSCI Japan.^[10] The stocks comprising the lowest 25% of the MSCI Japan had a six-month aggregate dollar value of average daily trading volume in excess of U.S. \$30 million: approximately U.S. \$1.506 billion for the 6-month period ending March 2002.^[11] The MSCI Japan is calculated in real time and is disseminated by electronic means through major data vendors.^[12]

OSE’s futures contracts on both Indices provide for cash settlement. The notional value for both futures contracts is determined by multiplying the relevant index by 10,000 Japanese Yen. Both futures contracts list for trading the five nearest months of the March quarterly cycle, and the last trading day for both futures contracts is the business day preceding the second Friday of the delivery month. Cash settlement must be completed by the second business day following the last trading day. The final settlement price for each contract is calculated based on a special opening quotation of the opening price for the constituent stocks in the respective Indices on the business day following the last trading day.^[13]

The Commodity Exchange Act (“CEA”),^[14] as amended by the Commodity Futures Modernization Act of 2000 (“CFMA”),^[15] 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,^[16] with the exception of security futures products,^[17] over which the Commission shares jurisdiction with the Securities and Exchange Commission (“SEC”).^[18] 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).^[19]

CEA Section 2(a)(1)(C)(iv) generally prohibits any person from offering or selling a futures contract based on a security index in the United States, except as permitted under CEA Section 2(a)(1)(C)(ii) or CEA Section 2(a)(1)(D).^[20] By its terms, CEA Section 2(a)(1)(C)(iv) applies to futures contracts on security indices traded on both domestic and foreign boards of trade. CEA Section 2(a)(1)(C)(ii) sets forth three criteria to govern the trading of futures contracts on a group or index of securities on designated contract markets and registered derivatives transaction execution facilities (“DTFs”):

- (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 security index.^[21]

While Section 2(a)(1)(C)(ii) provides that no board of trade or DTF may trade a security index futures contract unless it meets the three criteria noted above, it does not explicitly address the standards to be applied to a foreign security index futures contract traded on a foreign board of trade. This Office has applied 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 security 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.^[22]

Accordingly, this Office has examined the FTSE Japan and the MSCI Japan and the futures contracts based thereon to determine whether the Indices and the futures contracts 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 electronic mail noted above, we have determined that both the FTSE Japan and the MSCI Japan, and OSE’s futures contracts based thereon, conform to these requirements.^[23]

In determining whether a foreign futures contract based on a foreign security 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 securities underlying the index. As noted above, the securities underlying the FTSE Japan are traded on the OSE and the TSE, and the securities underlying the MSCI Japan are traded on the OSE, TSE, and the NSE. The OSE, TSE, NSE and other Japanese stock exchanges have been working in a mutual cooperative framework for market surveillance in order to prevent unfair transactions in the derivatives markets and cash stock markets under the administrative guidance of the FSA.^[24] Moreover, OSE represents that it has been able to obtain all necessary information for surveillance from the TSE with regard to the OSE’s Nikkei Stock Average 225 futures contract and OSE’s Nikkei Stock Index 300 futures contract.^[25]

Thus, OSE should have access to information necessary to detect and deter manipulation. In the event that OSE 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. [\[26\]](#)

In light of the foregoing, this Office 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 OSE's futures contracts based on the FTSE Japan and the MSCI Japan are offered or sold in the U.S. Because this position is based upon facts and representations contained in the letters, attachments, facsimiles and electronic mail 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 OSE 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 may adopt regarding futures contracts based on non-narrow-based security indices.

The offer and sale in the U.S. of OSE's futures contracts on the FTSE Japan and the MSCI Japan 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. [\[27\]](#)

Sincerely,

Patrick J. McCarty
General Counsel

[\[1\]](#) See letter from Nancy Jacklin, Esq., Clifford Chance US LLP, to David R. Merrill, Deputy General Counsel, CFTC, dated July 2, 2002.

[\[2\]](#) *Id.*

[\[3\]](#) *Id.*

[\[4\]](#) See *id.* and letter from David Felsenthal, Esq., Clifford Chance US LLP, to David R. Merrill, Deputy General Counsel, CFTC, dated November 22, 2002.

[\[5\]](#) See letter from Ms. Jacklin to Mr. Merrill, dated July 2, 2002.

[\[6\]](#) See letter from Mr. Felsenthal to Mr. Merrill, dated November 22, 2002.

[7] See letter from Ms. Jacklin to Mr. Merrill, dated July 2, 2002.

[8] *Id.*

[9] *Id.*

[10] *Id.*

[11] See letter from Mr. Felsenthal to Mr. Merrill, dated November 22, 2002.

[12] See letter from Ms. Jacklin to Mr. Merrill, dated July 2, 2002.

[13] *Id.*

[14] 7 U.S.C. § 1 *et seq.*

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

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

[17] 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).

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

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

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

[21] 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 of 1934 (“Exchange Act”), 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); Exchange Act Section 3(a)(55)

(B)(i)-(iv). 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). *See also* CEA Section 1a(25)(B); Exchange Act Section 3(a)(55)(C).

[22] With regard to the third criterion, the CFTC and SEC jointly promulgated Rule 41.13 under the CEA and Rule 3a55-3 under the Exchange Act, governing security index futures contracts traded on foreign boards of trade. These rules provide that “[w]hen a contract of sale for future delivery on a security index is traded on or subject to the rules of a foreign board of trade, such index shall not be a narrow-based security index if it would not be a narrow-based security index if a futures contract on such index were traded on a designated contract market or registered derivatives transaction execution facility.” CFTC Rule 41.13, 17 C.F.R. § 41.13; Exchange Act Rule 3a55-3, 17 C.F.R. § 240.3a55-3.

[23] In making this determination, the Commission staff has concluded that neither the FTSE Japan nor the MSCI Japan have any of the elements of a narrow-based security index as enumerated in CEA Section 1a(25)(A), and accordingly the Indices would not be narrow-based security indices if traded on a designated contract market or DTF.

[24] *See* letter from Ms. Jacklin to Mr. Merrill, dated July 2, 2002. Specifically, OSE reports and exchanges information necessary for coordinated surveillance of stocks and derivatives trading with TSE and NSE. This information includes daily market reports of derivatives trading; positions established with index arbitrage and program trading in the cash markets of the other stock exchanges; state of market orders immediately before the opening of the trading session on the day the special quotation is calculated; information regarding large lot open interests in equity options trading held by transaction participants; and other information upon request. In addition, OSE contacts other Japanese stock exchanges, as the need arises, and exchanges information necessary for coordinated surveillance of stocks and derivatives trading with those exchanges. *See* letter from Mr. Felsenthal to Mr. Merrill, dated November 22, 2002.

[25] *See* letter from Ms. Jacklin to Mr. Merrill, dated July 2, 2002. Commission staff issued no-action relief to OSE with regard to its Nikkei Stock Average 225 futures contract, *see* CFTC Staff Letter No. 92-1 [1990-1992 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 25,209 (January 16, 1992), and its Nikkei Stock Index 300 futures contract, *see* CFTC Staff Letter No. 94-43 [1992-1994 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 26,071 (May 17, 1994).

[26] OSE has agreed that it will cooperate with CFTC requests for information made pursuant to this no-action letter. *See* letter from Ms. Jacklin to Mr. Merrill, dated July 2, 2002. In addition, OSE is a signatory to the International Information Sharing Memorandum of Understanding, dated March 15, 1996. As of October 18, 2002, OSE also is an affiliate member of the Intermarket Surveillance Group (“ISG”). *See* letter from Mr. Felsenthal to Mr. Merrill, dated November 22, 2002. The members of ISG have agreed to share information to ensure coordinated surveillance of intermarket trading abuses.

On May 17, 2002, OSE's regulator, the FSA, signed a Statement of Intent Concerning Cooperation, Consultation and the Exchange of Information ("SOI") with the SEC and the CFTC. The FSA has confirmed that it is willing and able to share with the CFTC upon request information, including market and surveillance data information with respect to the ultimate customer to a transaction, concerning OSE's futures contracts and the constituent securities of the FTSE Japan and the MSCI Japan, pursuant to the SOI. *See* letter from Naohiko Matsuo, Director for International Financial Markets, International Affairs Division, FSA, to David R. Merrill, Deputy General Counsel, CFTC, dated October 2, 2002.

[\[27\]](#) *See* 17 C.F.R. Part 30.