

CFTC Letter No. 04-16
June 2, 2004
No-Action
Office of General Counsel

Michael S. Sackheim, Esq.
Sidley Austin Brown & Wood LLP
787 Seventh Avenue
New York, NY 10019

Re: No-Action Request to Permit the Offer and Sale in the United States of Futures Contracts on the Taiwan Stock Exchange Capitalization Weighted Stock Index Traded on the Taiwan Futures Exchange

Dear Mr. Sackheim:

This is in response your letters, attachments, facsimiles and electronic mail dated from December 17, 2003 to February 25, 2004, requesting on behalf of the Taiwan Futures Exchange (“TAIFEX”) 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 TAIFEX’s futures contracts based on the Taiwan Stock Exchange Capitalization Weighted Stock Index (“TAIEX” or “Index”), the TAIEX futures contract and the Mini TAIEX futures contract.

We understand the facts to be as follows. TAIFEX is a futures exchange in Taiwan founded in 1997 pursuant to the joint efforts of the Taiwanese government and the private sector.^[1] Originally named the Taiwan International Mercantile Exchange, the exchange’s name was changed to TAIFEX in 1999. TAIFEX was granted a corporate license, and its Board of Directors were selected as the highest executive body of the exchange. The principal regulatory authority in Taiwan having oversight over the exchange is the Taiwan Securities and Futures Commission (“SFC”). The SFC has broad supervisory responsibility for all aspects of securities and futures trading, including inspection, supervision, surveillance and enforcement. The Futures Trading Law of 1997, enforced by the SFC, is the principal statute under which TAIFEX operates.^[2]

The TAIEX is a broad-based, market capitalization-weighted composite index designed to reflect the overall performance of stocks traded on the Taiwan Stock Exchange Corporation (“TSEC”).^[3] The Index includes all of the listed stocks on the TSEC, excluding preferred stocks, full-delivery stocks^[4] and newly listed stocks that are listed for less than one calendar month. Based on data supplied by TAIFEX, the total adjusted market capitalization of the TAIEX was approximately U.S. \$352.03 billion as of November 27, 2003.^[5] Also as of that date, the largest single security by weight represented 10.63%, and the five most heavily weighted securities represented 24.75%, of the TAIEX.^[6] The

securities comprising the lowest 25% of the TAIEX had six-month aggregate dollar values of average daily trading volume in excess of U.S. \$30 million: approximately U.S.\$ 1.16 billion for the 6-month period ending November 2003.^[7] The TAIEX is calculated in real time and is disseminated by electronic means through major data vendors, such as Bloomberg and Reuters.^[8]

TAIFEX's TAIEX futures contract and Mini TAIEX futures contract commenced trading on July 21, 1998, and October 12, 2001, respectively. Both contracts provide for cash settlement. Prices are quoted in Index points with each Index point equal to NT\$ 200 for the TAIEX futures contract and NT\$ 50 for the Mini TAIEX futures contract.^[9] The terms and conditions of the contracts are otherwise identical. The minimum price fluctuation is one Index point per contract. The contracts are listed for trading from 8:45 AM to 1:45 PM Taiwan time Monday through Friday. TAIFEX lists for trading the spot month, the next calendar month, and the next three quarter months. The last trading day is the third Wednesday of the delivery month. Cash settlement occurs on the first business day after the last trading day. The final cash settlement price for the contracts is calculated based on the first fifteen minute volume-weighted average of each component stock's prices on the final settlement day.^[10]

The Commodity Exchange Act ("CEA"),^[11] as amended by the Commodity Futures Modernization Act of 2000 ("CFMA"),^[12] provides that the offer or sale in the U.S. 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,^[13] with the exception of security futures products,^[14] over which the Commission shares jurisdiction with the Securities and Exchange Commission ("SEC").^[15] 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).^[16]

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 U.S., except as permitted under CEA Section 2(a)(1)(C)(ii) or CEA Section 2(a)(1)(D).^[17] 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 ("DTEFs"):

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.^[18]

While Section 2(a)(1)(C)(ii) provides that no board of trade or DTEF 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 U.S. 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 DTEF to trade those products.^[19]

Accordingly, this Office has examined the TAIEX, and TAIFEX's futures contracts based thereon, to determine whether the Index 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 the TAIEX and TAIFEX's TAIEX futures contract and Mini TAIEX futures contract based thereon, conform to these requirements.^[20]

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. All of the stocks underlying the TAIEX are traded on the TSEC.^[21] On June 30, 2000, TAIFEX entered into a joint surveillance and information sharing agreement with the TSEC, as well as the GreTai Securities Market (the Taiwan over-the-counter market) and the Taiwan Securities Central Depository Co., Ltd., for the exchange of market and surveillance information.^[22] Thus, TAIFEX should have access to information necessary to detect and deter manipulation.^[23] In the event that TAIFEX 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.^[24]

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 TAIFEX's TAIEX futures contract and Mini TAIEX futures contract 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 TAIFEX with all regulatory requirements imposed by the SFC, and the applicable laws and regulations of Taiwan. 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 TAIFEX's futures contracts on the TAIEX is, of course, subject to Part 30 of the Commission's regulations, which governs the offer and sale of foreign futures and foreign option contracts in the U.S.^[25]

Sincerely,

Patrick J. McCarty

General Counsel

cc: Mr. Rick Ruzicka
Director, Trade and Commercial Programs
American Institute in Taiwan

^[1] See letter from Michael S. Sackheim, Sidley Austin Brown & Wood, LLP, to Patrick J. McCarty, General Counsel, CFTC, dated December 17, 2003.

^[2] *Id.*

^[3] *Id.* The TSEC was established in October 1961, and trading began on February 9, 1962. The TSEC calculates 28 indices, and the TAIEX is the most widely quoted of the TSEC indices. As of November 27, 2003, stocks of 637 companies listed on the TSEC representing 20 industry groups were components of the TAIEX. *Id.*

^[4] Unlike trading of regular common stocks in which transactions are settled or closed on the first business day immediately after the transaction day and in which stocks bought and sold, and consideration thereof, on the same day, can be offset against each other, “full delivery” stocks as declared by TSEC can only be traded by “full payment” in advance and no offset is permitted during the intra-day transactions. Margin trades are not permitted for the transaction of “full delivery” shares. The main purpose of this measure is to restrict the liquidity of the stocks of financially troubled companies, and thus these “full delivery” shares are excluded from computation of the Index. *Id.*

^[5] *Id.*

^[6] *Id.*

^[7] See letter from Michael S. Sackheim, Sidley Austin Brown & Wood LLP, to David R. Merrill, Deputy General Counsel, CFTC, dated February 5, 2004.

^[8] See letter from Mr. Sackheim to Mr. McCarty, dated December 17, 2003.

^[9] “NT\$” is an acronym for New Taiwan Dollars, the Taiwanese currency.

^[10] *Id.* For those component stocks that are not traded during the beginning fifteen minute interval on the final settlement day, their last closing prices would be applied. *Id.*

^[11] 7 U.S.C. § 1 *et seq.*

[12] Appendix E of Pub. L. No. 106-554, 114 Stat. 2763 (2000).

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

[14] 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).

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

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

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

[18] 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).

[19] 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.

[20] In making this determination, Commission staff has concluded that the TAIEX does not have any of the elements of a narrow-based security index as enumerated in CEA Section 1a(25)(A), and accordingly the Index would not be a narrow-based security index if traded on a designated contract market or DTEF.

[21] TAIFEX represents that the TSEC has access to all material information necessary to conduct proper surveillance of securities traded on the TSEC. *See* letter from Mr. Sackheim to Mr. McCarty, dated December 17, 2003.

[22] Pursuant to this agreement, all parties are required to share with each other information regarding (i) domestic and foreign material political and economic extraordinary events, (ii) major trading defaults, and (iii) failures or interruptions of trading systems. TSEC is required to provide the other contracting parties information regarding (i) financial crises or material fraud of securities firms, (ii) material delay in settlement by securities firms, (iii) material illegal trading by securities firms or investors or the initiation of material litigation concerning securities firms, and (iv) listed company involvement in financial crises or material fraud. TAIFEX is required to provide the other contracting parties information regarding (i) financial crisis or material fraud by futures commission merchants (“FCMs”), introducing brokers (“IBs”), or its clearing members, (ii) open positions that reach certain threshold amounts, (iii) clearing members’ material default in making the applicable margin payments and (iv) material illegal trading by FCMs, IBs, and clearing members or investors, or the initiation of material litigation concerning FCMs, IBs and clearing members. In addition, all parties to the agreement have agreed to notify each other of other matters deemed as potential threats to the structural security of cross-market operations, and to share additional information with each other pursuant to written requests. *Id.*

[23] TAIFEX represents that it has access to all material information necessary to conduct proper surveillance of futures contracts traded on TAIFEX. *Id.*

[24] In this regard, TAIFEX represents that there are no blocking statutes in Taiwan that could impact the ability of the CFTC or other U.S. government agencies from obtaining information concerning the trading of TAIFEX’s futures contracts. *See* letter from Mr. Sackheim to Mr. Merrill, dated February 5, 2004. Moreover, TAIFEX has agreed to cooperate with any CFTC requests for information regarding its futures contracts on the TAIEX. *See* letter from Mr. Sackheim to Mr. McCarty, dated December 17, 2003. TAIFEX also is a signatory to the International Information Sharing Memorandum of Understanding and Agreement signed on March 15, 1996, at Boca Raton, Florida.

On January 11, 1993, a Memorandum of Understanding between the American Institute in Taiwan and the Coordination Council for North American Affairs on the Exchange of Information Concerning Commodity Futures and Options Matters (“MOU”), was entered into by The American Institute in Taiwan, on behalf of the CFTC, and the Coordination Council for North American Affairs, now the Taipei Economic and Cultural Representative Office in the U.S., on behalf of Taiwan’s regulator, the SFC. The MOU established arrangements to exchange supervisory, surveillance, and investigatory information between the regulatory authorities in Taiwan and the U.S. in securing compliance with laws, rules and regulations regarding futures matters. The SFC has represented that it is willing and able to exchange information with the CFTC regarding TAIFEX’s futures contracts pursuant to the MOU. *See* letter from Sherry Wang, Director, Division of Futures and Options Markets, SFC, to Patrick J. McCarty, General Counsel, CFTC, dated December 29, 2003. The SFC also is a signatory to the Declaration on Cooperation and Supervision of International Futures Markets and Clearing Organizations, as amended, signed on March 15, 1996 at Boca Raton, Florida.

[\[25\]](#) *See* 17 C.F.R. Part 30.