



## U.S. COMMODITY FUTURES TRADING COMMISSION

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Office of General Counsel

CFTC letter No. 05-04  
March 14, 2005  
No-Action  
Office of General Counsel

Tina Woo, Esq.  
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31 West 52<sup>nd</sup> Street  
New York, NY 10019-6131

Re: Osaka Securities Exchange Co., Ltd.'s Request for No-Action Relief in Connection with the Offer and Sale in the United States of its Futures Contract Based on the Russell/Nomura Prime Index

Dear Ms. Woo:

This is in response to letters, attachments, facsimiles and electronic mail dated from November 11, 2004 to January 19, 2005, requesting on behalf of your client, the Osaka Securities Exchange Co., Ltd. ("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 contract based on the Russell/Nomura Prime Index ("RNP" or "Index").

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.<sup>1</sup> 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 contracts and options on security indices and options on securities.<sup>2</sup>

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

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<sup>1</sup> See letter from Tina Woo, Esq., Clifford Chance US LLP, to Patrick J. McCarty, General Counsel, CFTC, dated November 11, 2004, at 1.

<sup>2</sup> *Id.* at 1-2.

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.<sup>3</sup>

The RNP is a broad-based, free-float capitalization-weighted index jointly developed and maintained by the Russell Investment Group (“Russell”) and Nomura Securities Company (“Nomura”).<sup>4</sup> The composition of the RNP is derived from 1,000 of the most highly capitalized and actively traded common stocks listed on all the stock exchanges in Japan: the Tokyo Stock Exchange (“TSE”), the Nagoya Stock Exchange (“NSE”), the Fukuoka Stock Exchange (“FSE”), the OSE and JASDAQ.<sup>5</sup> The 995 stocks currently in the RNP, after mergers and delistings, represent 91% of the market value of the Japanese equity markets.<sup>6</sup> Based on data supplied by OSE, the total free-float adjusted market capitalization of the RNP was U.S. \$1.74 trillion as of September 30, 2004.<sup>7</sup> As of that date, the largest single stock by weight represented 4.83%, and the five most heavily weighted stocks represented 12.37%, of the adjusted market capitalization of the RNP.<sup>8</sup> The stocks comprising the lowest 25% of the RNP had a six-month aggregate dollar value of average daily trading volume in excess of U.S. \$30 million: approximately U.S. \$3.19 billion for the 6-month period ending September 30, 2004.<sup>9</sup> The RNP is calculated in real time and disseminated by QUICK Corporation, on

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<sup>3</sup> *Id.* at 2.

<sup>4</sup> *Id.* at 2. Nomura’s Index Products Group, which is within Nomura’s Financial & Economic Research Center, is in charge of managing the RNP. Rules regarding the inclusion of constituent stocks and weightings are established by Russell and Nomura. Nomura also convenes the “Nomura Index Policy Committee,” which includes staff from Russell and independent industry practitioners, to determine the validity of Index rules.

<sup>5</sup> *Id.* at 3.

<sup>6</sup> *Id.*

<sup>7</sup> *Id.* at 5. See data file entitled “Appendix C Table 1&2.xls,” attached to the electronic mail from Tina Woo, Esq., dated January 19, 2005.

<sup>8</sup> *Id.*

<sup>9</sup> See *id.* and data file entitled “Appendix C Table 3.xls,” attached to the electronic mail from Tina Woo, Esq., dated January 19, 2005.

consignment from Nomura, through electronic means to major data vendors, including Bloomberg and Reuters.<sup>10</sup>

OSE's RNP futures contract, which will commence trading in April 2005, provides for cash settlement. The notional value of the contract is determined by multiplying the Index level by 10,000 Japanese yen. OSE lists for trading five months of the March quarterly cycle, and the last trading day of the contract is the business day prior to the second Friday of each contract month. Cash settlement must be completed by the second business day following the last trading day based on the final settlement price. The final settlement price for the contract is calculated by QUICK Corporation based on a special opening quotation for the constituent stocks in the Index on the business day following the last trading day.<sup>11</sup>

The Commodity Exchange Act ("CEA"),<sup>12</sup> as amended by the Commodity Futures Modernization Act of 2000 ("CFMA"),<sup>13</sup> 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,<sup>14</sup> with the exception of security futures products,<sup>15</sup> over which the Commission shares jurisdiction with the Securities and Exchange Commission ("SEC").<sup>16</sup> 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).<sup>17</sup>

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<sup>10</sup> See letter from Ms. Woo to Mr. McCarty, dated November 11, 2004, at 3 & Appendix B.

<sup>11</sup> See letter from Tina Woo, Esq. to David R. Merrill, Deputy General Counsel, CFTC, dated January 19, 2005, Appendix III and letter from Ms. Woo to Mr. McCarty, dated November 11, 2004, at 7.

<sup>12</sup> 7 U.S.C. § 1 *et seq.*

<sup>13</sup> Appendix E of Pub. L. No. 106-554, 114 Stat. 2763 (2000).

<sup>14</sup> See CEA Section 2(a)(1)(C)(ii).

<sup>15</sup> 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).

<sup>16</sup> See CEA Section 2(a)(1)(D).

<sup>17</sup> See CEA Section 2(a)(1)(C)(ii).

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).<sup>18</sup> 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.<sup>19</sup>

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.<sup>20</sup>

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<sup>18</sup> CEA Section 2(a)(1)(D) governs the offer and sale of security futures products.

<sup>19</sup> 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).

<sup>20</sup> 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

Accordingly, this Office has examined the RNP and OSE's 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 electronic mail noted above, we have determined that the RNP and OSE's futures contract based thereon conform to these requirements.<sup>21</sup>

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 RNP are traded on the TSE, NSE, FSE, OSE and JASDAQ. The OSE, TSE, NSE and FSE 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.<sup>22</sup> OSE represents that it is able to obtain all necessary information from these exchanges for surveillance.<sup>23</sup> The JASDAQ, which was the Japanese over-the-counter market, recently became licensed as an exchange in Japan, and OSE and JASDAQ have

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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.

<sup>21</sup> In making this determination, the Commission staff has concluded that the RNP 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 DTF.

<sup>22</sup> See letter from Ms. Woo to Mr. McCarty, dated November 11, 2004, at 7. Specifically, OSE reports and exchanges information necessary for coordinated surveillance of stocks and derivatives trading with TSE, NSE and FSE. 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 *id.*, Appendix F.

<sup>23</sup> *Id.* at 7.

reached agreement on the general outline of a surveillance sharing agreement.<sup>24</sup> 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.<sup>25</sup>

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 contract based on the RNP is 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 contract on the RNP 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.<sup>26</sup>

Sincerely,

Patrick J. McCarty  
General Counsel

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<sup>24</sup> See letter from Ms. Woo to Mr. Merrill, dated January 19, 2005, at 4. Securities with a primary listing on JASDAQ represent 0.55% of the weight of the Index.

<sup>25</sup> OSE has agreed that it will cooperate with CFTC requests for information made pursuant to this no-action letter. See letter from Ms. Woo to Mr. McCarty, dated November 11, 2004, at 7. Moreover, OSE is a signatory to the International Information Sharing Memorandum of Understanding, dated March 15, 1996. OSE also is an affiliate member of the Intermarket Surveillance Group ("ISG"), which consists of representatives from securities and futures exchanges in the U.S. and other countries. The members of ISG have agreed to share information to ensure coordinated surveillance of intermarket trading abuses. *Id.* In addition, 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 on May 17, 2002.

<sup>26</sup> See 17 C.F.R. Part 30.