

CFTC Letter No. 99-25**July 14, 1999****No-Action****Office of General Counsel**

Philip McBride Johnson, Esq.

Skadden, Arps, Slate, Meagher & Flom LLP

1440 New York Avenue, N.W.

Washington, D.C. 20005-2111

Re: Hong Kong Futures Exchange ("HKFE") Request for No-Action Letter for Futures Contract Based on the HKFE Taiwan Index

Dear Mr. Johnson:

This is in response to letters and facsimiles dated from March 30, 1998 through April 20, 1999 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 of the Hong Kong Futures Exchange ("HKFE") futures contract based on the HKFE Taiwan Index ("Taiwan Index" or "Index")¹

We understand the facts to be as follows. The HKFE is located in Hong Kong and is regulated by the Securities and Futures Commission of Hong Kong ("SFC"). The SFC is responsible for regulating the securities, futures and leveraged foreign exchange markets in Hong Kong. The operations of the SFC are governed by the Commodities Trading Ordinance, Laws of Hong Kong. The functions of the SFC include supervising and monitoring the activities of exchanges and clearinghouses, including the HKFE and its wholly-owned subsidiary, HKFE Clearing Corporation Limited. The SFC is an independent statutory body, is responsible to the Hong Kong Special Administrative Region Government for the discharge of its duties, and reports to the Financial Secretary.

The Taiwan Index was created and is owned by the HKFE. The Index was created to track the trading activity of the Taiwan stock market. The Index is a capitalization-weighted index (without reference to dividend payments) and includes the stocks of sixty constituent companies. Constituent companies in the Index are reviewed by the HKFE on a quarterly basis

and all changes made are announced at least two weeks prior to the effective date. The stocks comprising the Taiwan Index represent 19 industry groups and include the largest capitalized stocks in each industry group in the Taiwan stock market. The three largest industries included in the Index are electronics (41.59 percent), banking and insurance (27.94 percent) and textiles (5.22 percent). As of March 31, 1999, the highest capitalized stock in the Taiwan Index, Taiwan Semiconductor Mfg. Co. Ltd., represented 12.25 percent of the Index. The five highest capitalized stocks in the Index accounted for 35.55 percent of the Index as of the same date and the total capitalization of the stocks included in the Index equaled over U.S. \$154 billion. The value of the Index is reported four times per minute (every 15 seconds) using recognized market data vendors. The calculation updates are performed for the HKFE by Bridge Information Systems Ltd., a subsidiary of Bridge Information Systems, Inc. of the United States. Actual Index computations are done at Bridge's headquarters in St. Louis, Missouri.

The HKFE Taiwan Index futures contract is a cash settled contract valued at U.S. \$10 times the value of the Index. The futures contract is denominated in U.S. dollars. The futures contract has a minimum fluctuation of one Index point, which is equal to U.S. \$10. There are no position limits for the futures contract but reporting limits are set at 500 contracts in any contract month. The final settlement price for the HKFE Taiwan Index futures contract is the average of values of the Index taken at five minute intervals starting at 11:30 a.m. and ending at 12:00 noon on the Last Trading Day.² The Taiwan Index futures contract has been trading over the HKFE's Automated Trading System since May 26, 1998.

The offer and sale in the United States of futures contracts traded on or subject to the rules of a foreign exchange is subject to the Commission's exclusive jurisdiction.³ Section 2(a)(1)(A), 7 U.S.C. § 2 (1994); 120 Cong. Rec. 34497 (1974) (statement of Senator Talmadge) (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).⁴ 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). In turn, Section 2(a)(1)(B)(ii) 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) 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 enumerated criteria. As noted above, we understand that the HKFE does not seek designation as a contract market. However, the House Committee on Agriculture suggested that a foreign board of trade could apply for "certification" that its stock index contract met all applicable Commission requirements. H.R. Rep. No. 565, Part 1, 97th Cong., 2d Sess. 85 (1982). The House Committee on Agriculture explained that a foreign exchange seeking certification for a futures contract based upon an index of American securities must demonstrate that the proposed futures contract meets the requirements set forth in Section 2(a)(1)(B)(ii). Id.

We understand that the securities in the HKFE Taiwan Index are issued by Taiwanese companies. The House Committee suggests that the Commission may use such criteria as it deems appropriate in evaluating a foreign stock index contract based on "foreign securities." Id. 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. We have examined the HKFE Taiwan Index futures contract in light of these requirements.⁵

Based on the information noted herein and as set forth in the letters, attachments and facsimiles noted above, 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 HKFE Taiwan Index futures contract traded on the HKFE is offered and sold in the United States. Because this position is based upon facts and representations contained in the above-noted letters, attachments and facsimiles, it should be noted that any different, omitted or changed facts or conditions might require a different conclusion.⁶ This position also is contingent on the continued compliance by the HKFE with all regulatory requirements imposed by the SFC and the applicable statutes of Hong Kong.

As you are aware, the Commission has adopted rules governing the offer and sale of foreign futures and foreign option contracts in the United States. See 17 C.F.R. Part 30. The offer and sale in the United States of the HKFE Taiwan Index futures contract is, of course, governed by these regulations.

Sincerely,

Daniel
R.
Waldman

General
Counsel

cc: Mike Walinskas

Associate Director

Division of Market Regulation

Securities and Exchange Commission

¹ By letter dated June 1, 1994, the Office of the General Counsel granted no-action relief to the HKFE for its futures contract based on the Hang Seng Index. See June 1, 1994 letter from Pat G. Nicolette, Acting General Counsel, Commission, to Ivers W. Riley, Chief Executive, HKFE.

² The last trading day generally is the business day at the Taiwan Stock Exchange immediately preceding the last business day of the contract month.

³ Section 12(e) of the Commodity Exchange Act prohibits the application of any federal or state statute to a transaction that is conducted on or subject to the rules of a foreign exchange "except as otherwise specified by the Commission by rule or regulation." 7 U.S.C. § 16(e) (1994). The Commission has authorized the application of state law to "any person required to be registered under . . . [17 C.F.R. Part 30] who solicits foreign futures and foreign options customers and who shall fail or refuse to obtain such registration, unless such person is exempt from such registration" 17 C.F.R. § 30.11 (1999).

⁴ In this regard, pursuant to the authority in, among other provisions, Section 4(b) of the Act, 7 U.S.C. § 6(b) (1994), the Commission has promulgated rules to regulate the offer and sale in the United States of foreign futures and options contracts. See 17 C.F.R. Part 30 (1999).

⁵ The staff of the Securities and Exchange Commission ("SEC") has informed us that they would have no objection to the offer and sale of this futures contract in the United States. See letter dated June 9, 1999 from Michael Walinskas, Associate Director, Division of Market Regulation, SEC, to Daniel R. Waldman, General Counsel, Commission.

⁶ On May 29, 1992, an agreement was entered into between the SFC and CFTC with respect to the sharing of confidential information between agencies. In addition, the SFC is a signatory to a Memorandum of Understanding ("MOU") with the Commission and the SEC dated October 5, 1995. In this connection, the SFC has confirmed that the October 5, 1995 MOU embraces activities involving the HKFE Taiwan Index futures contract. See August 5, 1998 letter from David White, Executive Director, SFC, to David Merrill, Deputy General Counsel, Commission. Further, the SFC is signatory to the Declaration on Cooperation and Supervision of International Futures Exchanges and Clearing Organizations for the sharing of large exposure information dated March 15, 1996. The HKFE also has represented that it will cooperate with the Commission in inquiries, investigations, and enforcement proceedings relating to the offer and sale in the U. S. of the Taiwan Index futures contract on the HKFE. See Letter dated March 30, 1998 to Daniel R. Waldman, General Counsel, Commission, from Philip McBride Johnson. The HKFE also is a signatory to the Memorandum of Understanding and Agreement signed on March 15, 1996 at Boca Raton, Florida.

In evaluating requests for no-action relief with regard to foreign futures contracts based on foreign stock indices, the Commission generally examines whether a surveillance sharing arrangement exists between the futures exchange and the securities exchange on which the underlying stocks are traded. In this regard, the HKFE has a MOU with the Taiwan Stock Exchange which covers surveillance and related matters. The types of information that may be shared include transaction data, clearing data and the identity of persons executing orders or holding large positions. See May 26, 1998 letter from Philip McBride Johnson to David Merrill, Deputy General Counsel, Commission.