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Office of General Counsel

CFTC Letter No. 09-01
January 16, 2009
No-Action
Office of General Counsel

Calvin Tai
Director
Hong Kong Futures Exchange Limited
12/F One International Finance Centre
1 Harbour View Street
Central, Hong Kong

Re: Hong Kong Futures Exchange Limited's Request for No-Action Relief in Connection with the Offer and Sale of its Mini Futures Contracts Based on the Hang Seng Index and the Hang Seng China Enterprises Index in the United States

Dear Mr. Tai:

This is in response to your letter dated March 7, 2008 and attachments, requesting on behalf of the Hong Kong Futures Exchange, Limited ("HKFE"), 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 of HKFE's mini futures contracts (collectively "mini futures") based on the Hang Seng Index ("HSI") and the Hang Seng China Enterprises Index ("HSCEI") (collectively, "Indices").[1]

We understand that all the representations about HKFE in your April 11, 2005 submission on HSCEI futures (attached as Appendix 1) remain true and correct, and are incorporated into your present submission. Based on your April 11, 2005 submission, HKFE is one of the major derivatives markets in Asia. In operation since 1976, HKFE has been recognized as an "exchange company" under the Securities and Futures Ordinance of the Laws of Hong Kong ("SFO") in order to operate a derivatives

[1] This Office previously has granted no-action relief in connection with HKFE's futures contracts on: 1) the HSCEI and the HSI, *see* CFTC Staff Letters No. 06-22, [2005-2007 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 30,366 (Sept. 26, 2006) and No. 94-50, [1992-1994 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 26,114 (June 1, 1994); and 2) the HKFE Taiwan Index, *see* CFTC Staff Letter No. 99-25, [1998-1999 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 27,715 (July 14, 1999).

market. HKFE and its wholly-owned subsidiary, HKFE Clearing Corporation Limited ("HKCC"), are subject to the regulatory oversight of the Hong Kong Securities and Futures Commission ("SFC"). SFC is responsible for enforcing the SFO and ensuring exchange participants' compliance with statutory requirements, including provisions related to market manipulation, financial requirements, internal control requirements, and the SFC's Code of Conduct for Persons Licensed by or Registered with the SFC.[2]

The HSI mini futures contract began trading on October 9, 2000 and the HSCEI mini futures contract began trading on March 31, 2008. The HSI is a broad-based, modified-free-float-adjusted-market-capitalization-weighted index designed to reflect the performance of the overall Hong Kong stock market.[3] The HSCEI is a broad-based, modified-free-float-adjusted-market-capitalization-weighted index composed of all H-share common stocks that are listed on the Stock Exchange of Hong Kong ("SEHK") and that are included in the Hang Seng Composite Index ("HSCI"). Compiled and managed by HSI Services Limited, the HSCEI is designed to reflect the overall performance of the H-share companies in the HSCI.[4]

As of January 31, 2008, there were 43 stocks in each of the Indices, with a total adjusted market capitalization of the HSI and the HSCEI of U.S. $652,770 million and U.S. $227,839 million, respectively.[5] Also as of that date, the largest single stock represented 15.56%, and the five most heavily weighted stocks accounted for 40.76% of the HSI.[6] The largest stock represented 10.5%, and the five most heavily weighted stocks accounted for 43.01% of the HSCEI. The stocks comprising the lowest 25% of the HSI and HSCEI over a six-month period ending January 31, 2008 had an aggregate value of average daily trading volume in excess of U.S. $30 million: approximately U.S. $1,528 million and U.S. $1,554 million, respectively.[7]

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[2] *See* letter from Calvin Tai, HKFE, to Julian E. Hammar, CFTC, dated April 11, 2005, at 1-4.

[3] *See* letter from Mr. Tai to Mr. Hammar, dated March 7, 2008, at 7.

[4] *See* letter from Mr. Tai to Mr. Hammar, dated April 11, 2005, at 10.

[5] Effective March 6, 2006, the weighting methodology of the HSCEI changed to a modified-free-float-adjusted market capitalization index (with a 15 percent cap on any component stock), from a market capitalization weighted methodology. *See* electronic mail from Ernest Po, HKFE, to Mr. Hammar, dated December 13, 2005.

[6] *See* letter from Calvin Tai to Mr. Hammar, dated March 7, 2008, at 8.

[7] *Id.* at 8-9.

HKFE's mini futures based on the HSI and HSCEI are cash-settled.[8] The notional value for the contracts is determined by multiplying the relevant index level by HK $10 (approximately U.S. $1.28).[9] Prices are quoted in index points with each index point equal to HK $10 per contract. The minimum price fluctuation is 1.00 index point (HK $10 per contract). HKFE lists for trading the spot month, the next calendar month, and the next two nearest months of the March quarterly cycle, and the last trading day of the contracts is the business day immediately preceding the last business day of the contract month. Cash settlement occurs on the first business day after the last trading day based on the final settlement price. The final settlement price for the contracts is calculated on the last trading day and is based on the relevant average of HSI and HSCEI observations taken in five minute intervals during the last trading 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

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[8] This Office previously issued no-action letters regarding the HKFE's standard-sized HSI and HSCEI futures contracts on June 1, 1994 and September 26, 2006, respectively. The subject mini futures contracts are identical to the standard-sized HSI and HSCEI futures contracts. The only substantive difference is the contract size (multiplier). See letter from Mr. Tai to Mr. Hammar, dated March 7, 2008, at 2.

[9] The HK/U.S. dollar spot rate on October 28, 2008 was 7.75 HK$ per U.S. dollar (see http://www.bloomberg.com/markets/currencies/asiapac_currencies.html)

[10] *See* letter from Mr. Tai to Mr. Hammar, dated March 7, 2008, at Appendix 2.

[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).

regard to a futures contract on a group or index of securities that is 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 designated contract market 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

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[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).

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 HSI and the HSCEI, and the mini futures based thereon, to determine whether the Indices and the mini futures 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 and attachments noted above, we have determined that the Indices and the mini futures 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. As noted above, all the securities underlying the HSI and HSCEI are traded on the SEHK. Both the HKFE and the SEHK are wholly owned subsidiaries of Hong Kong Exchanges Clearing Limited ("HKEx"). HKEx is the "recognized exchange controller" (which is a person recognized by the SFC as the shareholder controller of a recognized exchange company) of both HKFE and SEHK, and is required under the SFO to ensure, so far as reasonably practicable, an orderly, informed and fair market in securities and futures contracts traded on the stock market and futures market operated by SEHK and HKFE. Both the SEHK and the HKFE may disclose information to each other and to HKEx pursuant to exchange rules.[21] Pursuant to a memorandum of understanding between SFC and HKEx, HKEx's obligations include conducting cross-market surveillance in connection with the markets operated by HKEx.[22] Thus, HKFE should have access to information necessary to detect and deter manipulation. In the event that HKFE is unable to obtain access to adequate surveillance data in this regard, or is unable to

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[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 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, the Commission staff has concluded that the HSI and HSCEI do not 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 DTEF.

[21] *See* letter from Mr. Tai to Mr. Hammar, dated March 7, 2008, at 5. *See also* letter from Mr. Tai to Mr. Hammar, dated April 11, 2005, at 7.

[22] *See* letter from Mr. Tai to Mr. Hammar, dated April 11, 2005, at 8.

share such data with the CFTC, this Office reserves the right to reconsider the position we have taken herein.[23]

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 HKFE's mini futures based on the HSI and HSCEI are offered or sold in the U.S. Because this position is based upon facts and representations contained in the letters and attachments 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 HKFE with all regulatory requirements imposed by the SFC, and the applicable laws and regulations of Hong Kong. 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.

HKFE also has requested that, upon issuance of the relief granted herein, it be permitted to make its mini futures based on the HSI and HSCEI available for trading by direct access through its HKATS electronic terminals in the U.S. in accordance with the terms and conditions of the foreign terminal no-action letter dated June 9, 2000, as amended July 30, 2001, issued by Commission staff to HKFE.[24] In this regard, HKFE has certified that it is in compliance with the terms and conditions of the June 9, 2000

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[23] HKFE has confirmed that it is willing and able to share with the Commission, either directly or indirectly through SFC or HKEx, information, including customer identification information, concerning its mini futures based on the HSI and HSCEI, and the securities underlying the respective Indices. *See* letter from Mr. Tai to Mr. Hammar, dated March 7, 2008, at 4-5. HKFE also is a signatory to the International Information Sharing Memorandum of Understanding and Agreement signed on March 15, 1996, at Boca Raton, Florida.

In addition, HKFE's regulator (the SFC) and the CFTC entered into a Memorandum of Understanding concerning Consultation and Cooperation in the Administration and Enforcement of Futures Laws (October 5, 1995). The SFC also is a signatory to the International Organization of Securities Commissions' Multilateral Memorandum of Understanding Concerning Consultation and Cooperation and the Exchange of Information ("IOSCO MOU"), to which the Commission also is a signatory. The IOSCO MOU is a multilateral mechanism for sharing surveillance information on a bilateral basis between regulators. Prior to signing the IOSCO MOU, a regulator must establish through a fair and transparent process that it has the legal capacity to fulfill its terms and conditions. Moreover, the SFC is a signatory to the Declaration on Cooperation and Supervision of International Futures Markets and Clearing Organizations for the sharing of large exposure information, signed on March 15, 1996, at Boca Raton, Florida.

[24] *See* CFTC Staff Letter No. 00-75 [1999-2000 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 28,180 (June 9, 2000) and CFTC Staff Letter No. 01-74 [2000-2002 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 28,612 (July 30, 2001).

foreign terminal no-action letter.[25] We have consulted with the Commission's Division of Market Oversight ("Division"), which is the Division in the Commission that administers foreign terminal no-action letters. The Division has concluded that allowing HKFE to make its mini futures on the HSI and HSCEI available for trading pursuant to the June 9, 2000 letter would not be contrary to the public interest. Accordingly, on behalf of the Division, this Office hereby confirms that the no-action relief granted to HKFE in the June 9, 2000 foreign terminal no-action letter extends to HKFE's mini futures based on the HSI and HSCEI.[26]

The offer and sale in the U.S. of HKFE's mini futures on the HSI and HSCEI 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.[27]

Sincerely,

Terry S. Arbit
General Counsel

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[25] *See* letter from Mr. Tai to Mr. Hammar, dated April 11, 2005, at 11-12 and letter from Mr. Tai to Mr. Hammar, dated September 20, 2005, at 10.

[26] Please be advised that if HKFE intends to list options on its mini futures based on the HSI and HSCEI, it may offer and sell those options in the U.S. with no further action from this Office, *see* 61 Fed. Reg. 10891 (March 18, 1996). However, if HKFE intends to make such options available for trading via direct access from electronic trading terminals in the U.S., HKFE must so notify the Division in accordance with the Notice of Revision of Commission Policy Regarding the Listing of New Futures and Option Contracts by Foreign Boards of Trade That Have Received Staff No-Action Relief to Provide Direct Access to Their Automated Trading Systems From Locations in the United States, issued on April 18, 2006. *See* 71 Fed. Reg. 19877 (April 18, 2006).

[27] *See* 17 C.F.R. Part 30.