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Office of General Counsel

CFTC letter No. 06-22
September 26, 2006
No-Action
Office of General Counsel

Calvin Tai
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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 in the United States of its Futures Contracts Based on the FTSE/Xinhua China 25 Index and the Hang Seng China Enterprises Index

Dear Mr. Tai:

This is in response to letters, attachments, facsimiles and electronic mail dated from April 11, 2005 to July 18, 2006, requesting on behalf of the Hong Kong Futures Exchange, Limited ("HKFE"), 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 HKFE's futures contracts based on the FTSE/Xinhua China 25 Index ("FXC") and the Hang Seng China Enterprises Index ("HSCEI") (collectively, "Indices").[1]

We understand the facts to be as follows. 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 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

[1] This Office previously has granted no-action relief in connection with HKFE's futures contracts on the Hang Seng Index, *see* CFTC Staff Letter No. 94-50, [1992-1994 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 26,114 (June 1, 1994), and 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).

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 FXC is a broad-based, modified-free-float-market-capitalization-weighted security index, composed of 25 of the largest and most liquid Chinese common stocks (Red Chip and H-shares) listed for trading on the Stock Exchange of Hong Kong ("SEHK").[3] FTSE/Xinhua Index Ltd. is responsible for the operation of the FXC.[4] As of April 30, 2005, the total market capitalization of the FXC was approximately U.S. $52.53 billion.[5] Also as of that date, the largest single stock by weight represented 10.4%, and the five most heavily weighted stocks represented 40.36%, of the FXC.[6] The stocks comprising the lowest 25% of the FXC had a six-month aggregate dollar value of average daily trading volume in excess of U.S. $30 million: approximately U.S. $122.2 million for the 6-month period ending April 2005.[7] The FXC is calculated in real time and disseminated every 15 seconds during the SEHK's trading hours to various information vendors, including Bloomberg, Reuters and Thomson.[8]

The HSCEI is a broad-based, modified-free-float-market-capitalization-weighted index composed of all H Share common stocks that are listed on the SEHK and are included in the Hang Seng Composite Index. Compiled and managed by HSI Services Limited, the HSCEI is designed to reflect the overall performance of the H-share

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

[3] "Red Chip" shares are SEHK-listed securities that are issued by companies that are incorporated in Hong Kong but which are substantially owned, directly or indirectly, by the Chinese Government and which have the majority of their business interest in mainland China. "H-shares" are securities of companies that are incorporated by the People's Republic of China (usually government-owned enterprises) and nominated by the Central Government for listing and trading on the SEHK. *See* letter from Calvin Tai, Senior Vice President, HKFE, to Julian E. Hammar, Counsel, CFTC, dated September 20, 2005, at Appendix 3, Ground Rules for the Management of the FTSE/Xinhua China 25 Index.

[4] *Id.* at 3.

[5] *Id.* at 7.

[6] *Id.* at 9.

[7] *Id.*

[8] *Id.* at 6.

companies in the Hang Seng Composite Index.[9] As of March 28, 2006, there were 37 stocks in the HSCEI, with a total market capitalization of approximately U.S. $209 billion.[10] Also as of that date, the largest single stock by weight represented 15.42%, and the five most heavily weighted stocks represented 58.71%, of the HSCEI. The stocks comprising the lowest 25% of the HSCEI had a six-month aggregate dollar value of average daily trading volume in excess of U.S. $30 million: approximately U.S. $178.1 million for the 6-month period ending March 2006.[11] The HSCEI is calculated in real time and disseminated every 15 seconds during the SEHK's trading hours to various information vendors, including Bloomberg, Reuters and Thomson.[12]

HKFE's futures contracts on both the FXC and HSCEI provide for cash settlement. The terms and conditions of both contracts largely are identical.[13] The notional value for the contracts is determined by multiplying the relevant index level by HK $50. Prices are quoted in index points with each index point equal to HK $50 per contract. The minimum price fluctuation is 1.00 index point (HK $50 per contract). HKFE lists for trading the spot month, the next calendar month, and the next two calendar quarter 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 FXC and HSCEI observations taken in five minute intervals during the SEHK's trading sessions.[14]

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

[10] 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 Julian E. Hammar, Counsel, CFTC, dated December 13, 2005.

[11] Data provided by Bloomberg Professional Services.

[12] *See* letter from Mr. Tai to Mr. Hammar, dated April 11, 2005, at 9.

[13] The only substantive difference between the two contracts is that the FXC Contract has an all-months-combined position limit of 6,000 contracts, while the HSCEI contract has a position limit of 6,000 contracts in any one contract month. *See* letter from Mr. Tai to Mr. Hammar, dated September 20, 2005, at Appendix 2 and letter from Mr. Tai to Mr. Hammar, dated April 11, 2005, at Appendix 1.

[14] *See* letter from Mr. Tai to Mr. Hammar, dated September 20, 2005, at Appendix 2 and letter from Mr. Tai to Mr. Hammar, dated April 11, 2005, at Appendix 1.

The Commodity Exchange Act ("CEA"),[15] as amended by the Commodity Futures Modernization Act of 2000 ("CFMA"),[16] 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,[17] with the exception of security futures products,[18] over which the Commission shares jurisdiction with the Securities and Exchange Commission ("SEC").[19] 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).[20]

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).[21] 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.[22]

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[15] 7 U.S.C. § 1 et seq.

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

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

[18] 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).

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

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

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

[22] 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

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.[23]

Accordingly, this Office has examined the FXC, the HSCEI, and HKFE's 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 the FXC, the HSCEI and HKFE's futures contracts based thereon, conform to these requirements.[24]

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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).

[23] 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.

[24] In making this determination, the Commission staff has concluded that the FXC 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. With regard to the HSCEI, in light of the weight as of March 28, 2006 of the five highest-weighted component securities at 58.71%, which is close to the 60% threshold in CEA

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 FXC 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 HKEx pursuant to exchange rules.[25] 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.[26] 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 share such data with the CFTC, this Office reserves the right to reconsider the position we have taken herein.[27]

Section 1a(25)(A)(iii), HKFE has represented that it will monitor the HSCEI weighting on a daily basis to determine whether the HSCEI is narrow-based security index for that trading day. HKFE also has represented that it will notify the Commission if the HSCEI is a narrow-based security index for more than 45 business days over 3 consecutive calendar months. *See* letter from Mr. Tai to Mr. Hammar, dated April 11, 2005, at 11. *See also* CEA Section 1a(25)(B)(iii); CEA Section 1a(25)(D); CFTC Rule 41.13, 17 C.F.R. § 41.13; and Exchange Act Rule 3a55-3, 17 C.F.R. § 240.3a55-3. The no-action relief provided herein is contingent upon, among other things, HKFE's compliance with these representations.

[25] *See* letter from Mr. Tai to Mr. Hammar, dated April 11, 2005, at 7.

[26] *Id.* at 8.

[27] 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 futures contracts based on the FXC and HSCEI, and the securities underlying the respective Indices. *See* letter from Mr. Tai to Mr. Hammar, dated September 20, 2005, at 4 and letter from Mr. Tai to Mr. Hammar, dated April 11, 2005, at 8. 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

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 futures contracts based on the FXC and HSCEI 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 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 futures contracts based on the FXC and HSCEI available for trading through its HKATS electronic terminals in the U.S. in accordance with the terms and conditions of the foreign terminal no-action letters dated June 9, 2000 and July 30, 2001, issued by Commission staff to HKFE.[28] In this regard, HKFE has certified that it is in compliance with the terms and conditions of the June 9, 2000 and July 30, 2001 no-action letters.[29] 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 futures contracts on the FXC and HSCEI available for trading pursuant to the June 9, 2000 and July 30, 2001 letters 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 and July 30, 2001 letters extends to HKFE's futures contracts based on the FXC and HSCEI.

Enforcement of Futures Laws (October 5, 1995). The SFC also is a signatory to the International Organization of Securities Commission's 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.

[28] *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).

[29] *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.

The offer and sale in the U.S. of HKFE's futures contracts on the FXC 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.[30]

Sincerely,

Nanette R. Everson
General Counsel

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