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Office of General Counsel

CFTC Letter No. 08-06
April 1, 2008
No-Action
Office of General Counsel

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New York, NY 10019

Re: Taiwan Futures Exchange's Request for No-Action Relief in Connection with the Offer and Sale in the United States of its Futures Contract Based on the Taiwan Stock Exchange Non-Finance Non-Electronic Sub-Index

Dear Mr. Sackheim:

This is in response to your letter and electronic mail dated December 21, 2007, 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 contract based on the Taiwan Stock Exchange Non-Finance Non-Electronic Sub-Index ("XIF" or "Index").[1]

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.[2] 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 was selected as the highest executive body of the Exchange. The principal regulatory

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[1] This Office previously has granted no-action relief in connection with TAIFEX's futures contracts on the MSCI Taiwan Index, *see* CFTC Staff Letter No. 06-28 [2005-2007 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 30,398 (Oct. 11, 2006); the Taiwan Stock Exchange Electronic Sector Index and the Taiwan Stock Exchange Finance Sector Index, *see* CFTC Staff Letter No. 05-08 [2005-2007 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 30,077 (May 16, 2005); and the Taiwan Stock Exchange Capitalization Weighted Stock Index, *see* CFTC Staff Letter No. 04-16, [2003-2004 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 29,781 (June 2, 2004).

[2] *See* letter from Michael S. Sackheim, Esq., Sidley Austin LLP, to Terry S. Arbit, General Counsel, CFTC, dated December 21, 2007, at 2.

authority in Taiwan having oversight over TAIFEX was the Taiwan Securities and Futures Commission ("SFC"). To achieve the goal of consolidated financial supervision, the Taiwan Legislative Yuan enacted the "Organic Act of the Financial Supervisory Commission, Executive Yuan," creating the new department of Financial Supervisory Commission, Executive Yuan ("FSC"), effective July 1, 2004. As a result, the SFC became subordinate to the FSC, and the SFC changed its name to "Securities and Futures Bureau, Financial Supervisory Commission" ("SFB"). The SFB has broad supervisory responsibility for all aspects of securities and futures trading in Taiwan, including inspection, supervision, surveillance and enforcement. The Futures Trading Law of 1997 ("FTL"), enforced by the SFB, is the principal statute under which TAIFEX operates.[3]

The XIF is a broad-based, market-capitalization-weighted security index composed of stocks that are listed for trading on the Taiwan Stock Exchange Corporation ("TSEC") and that are not financial- or electronics-related stocks.[4] Maintained by the TSEC, the Index had stocks of 325 TSEC-listed companies as of October 31, 2007. Based on data supplied by TAIFEX, the total adjusted market capitalization of the XIF was approximately U.S. $234.2 billion.[5] The largest single stock by weight represented 12.80%, and the five most heavily weighted stocks represented 43.27%, of the XIF.[6] The stocks comprising the lowest 25% of the XIF had a six-month aggregate dollar value of average daily trading volume in excess of U.S. $30 million: approximately U.S. $621.9 million for the 6-month period ending October 31, 2007.[7] The XIF is calculated in real time and disseminated every minute during trading hours to various information vendors, including Bloomberg and Reuters.[8]

TAIFEX's futures contract on the XIF began trading on October 8, 2007. The contract provides for cash settlement. Prices are quoted in Index points, with each Index point equal to NTD 100 per contract. The minimum price fluctuation is 1 Index point (NTD 100 per contract). TAIFEX lists for trading the spot month, the next calendar month, and the next three months of

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[3] *Id.*

[4] *Id.* at 6. The XIF also excludes preferred stocks, full-delivery stocks and newly listed stocks that are listed for less than one calendar month. Full-delivery stocks as declared by TSEC can only be traded by "full payment" in advance and no offset is permitted during intra-day transactions, unlike trading of regular common stocks on TSEC. 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.* at 10.

[6] *Id.* at 6.

[7] *Id.* at 10.

[8] *Id.*

the March quarterly cycle. The last trading day of the contract is the third Wednesday of the delivery month. Cash settlement occurs on the final settlement day, which is the first business day after the last trading day, based on the final settlement price. The final settlement price for the contract is calculated based on the volume-weighted average price of each component stock during the first fifteen minutes of trading on the final settlement day.[9]

The Commodity Exchange Act ("CEA"),[10] as amended by the Commodity Futures Modernization Act of 2000 ("CFMA"),[11] 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,[12] with the exception of security futures products,[13] over which the Commission shares jurisdiction with the Securities and Exchange Commission ("SEC").[14] 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).[15]

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).[16] 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;

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[9] *Id.* at 3-4. For those component stocks that are not traded during the beginning fifteen minute interval on the final settlement day, their opening reference prices are applied instead. *Id.* at 4.

[10] 7 U.S.C. § 1 *et seq.*

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

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

[13] 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).

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

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

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

(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.[17]

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.[18]

Accordingly, Commission staff has examined the XIF and TAIFEX'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 letter and electronic mail noted above, we have determined that the XIF, and TAIFEX's futures contract based thereon, conform to these requirements.[19]

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[17] 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).

[18] 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.

[19] In making this determination, Commission staff has concluded that the XIF does not have any of the elements of a narrow-based security index as enumerated in CEA Section 1a(25)(A).

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 XIF are traded on the TSEC.[20] On June 30, 2000, TAIFEX entered into a joint surveillance and information sharing agreement with the TSEC, as well as the GreTai Securities Market and the Taiwan Securities Central Depository Co., Ltd., for the exchange of market and surveillance information.[21] Thus, TAIFEX should have access to information necessary to detect and deter manipulation.[22] 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 taken herein.[23]

Accordingly, the Index would not be a narrow-based security index if traded on a designated contract market or DTEF.

[20] 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. Arbit, dated December 21, 2007, at 14.

[21] 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 crises 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 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.*

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

[23] TAIFEX has agreed to cooperate with any CFTC requests for information regarding its futures contract on the XIF. *Id.* TAIFEX 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, TAIFEX recently was issued an exemptive order by the Commission pursuant to Commission Regulation 30.10, 17 C.F.R. 30.10, under which TAIFEX has represented that it will cooperate with the Commission with regard to any inquiries concerning

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 futures contract based on the XIF 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 TAIFEX with all regulatory requirements imposed by the SFB, 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 contract on the XIF 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.[24]

Sincerely,

Terry S. Arbit
General Counsel

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foreign futures and options transactions. *See* 72 Fed. Reg. 14413 (March 28, 2007). On January 11, 1993, a Memorandum of Understanding 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 TAIFEX's regulator, now the SFB. 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 SFB has represented that it is willing and able to exchange information with the CFTC regarding trading in TAIFEX's futures contracts pursuant to the MOU. *See* letter from Sherry Wang, Director, Division of Futures and Options Markets, SFB, to Patrick J. McCarty, General Counsel, CFTC, dated December 29, 2003. The SFB, through its predecessor, 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.

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