



U.S. COMMODITY FUTURES TRADING COMMISSION

Three Lafayette Centre
1155 21st Street, NW, Washington, DC 20581
Telephone: (202) 418-5120
Facsimile: (202) 418-5524

Office of General Counsel

CFTC Letter No. 08-20
November 26, 2008
No-Action
Office of General Counsel

Philip McBride Johnson, Esq.
Skadden, Arps, Slate, Meagher & Flom LLP
1440 New York Avenue, NW
Washington, DC 20005-2111

Re: Korea 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 KOSPI 200 Stock Index Futures Contract

Dear Mr. Johnson:

This is in response to your letters, attachments, facsimiles and electronic mail dated from June 10, 2004 to September 22, 2008, requesting on behalf of the Korea Exchange ("KRX"), that the Office of General Counsel ("Office") of the Commodity Futures Trading Commission ("Commission" or "CFTC") issue a "no-action" letter in connection with the offer and sale in the United States of KRX's futures contract based on the KOSPI 200 Stock Index ("KOSPI 200" or "Index").

We understand the facts to be as follows. KRX is the derivatives and securities exchange of the Republic of Korea ("Korea"), formed as a result of the merger of the Korean Stock Exchange ("KSE"), the KOSDAQ market and the Korean Futures Exchange ("KOFEX"), on January 27, 2005. The three formerly independent exchanges are now divisions of the KRX, which is headquartered in Busan. A Market Oversight Commission, an internal agency of the KRX, performs self-regulatory duties with regard to the divisions, and conducts market surveillance within and across KRX's markets with the aim to prevent unfair trading practices such as manipulation.¹

KRX is regulated by the Korea Financial Services Commission ("FSC"), formerly the Korea Financial Supervisory Commission.² Launched on March 3, 2008, the FSC is under the

¹ Further information on KRX is available on its English language website, <<http://eng.krx.co.kr/index.html>>.

² See electronic mail from Philip McBride Johnson, Esq., Skadden, Arps, Slate, Meagher & Flom LLP to Julian E. Hammar, Assistant General Counsel, CFTC, dated August 19, 2008, (Attachment 1, Act on the Establishment, Etc. of Financial Services Commission). Further

jurisdiction of the Prime Minister and was established to advance the Korean financial industry, stabilize financial markets, and promote a sound credit system and fair trading practices. Within the FSC, there is a Securities and Futures Commission (“SFC”) that is responsible for, among other things, investigation of unfair trading and matters delegated from the FSC for the management, monitoring and supervision of the Korean securities and futures markets. Another regulatory body in Korea, the Financial Supervisory Service, conducts examinations of financial institutions and performs other duties delegated by the FSC. Pursuant to the Act on Real Name Financial Transactions and Guarantee of Secrecy, as amended, the FSC is authorized to supply transaction information to a foreign financial regulatory authority upon receiving a request for such information.³

The KOSPI 200 is a broad-based, free-float, market-capitalization-weighted index composed of 200 major stocks currently listed on KRX and is a widely recognized benchmark of Korean stock market activity. KRX owns and maintains the Index. Through its Stock Price Index Policy Committee, KRX selects, manages, publishes and reviews the KOSPI 200 on an annual basis ending on the last trading day in April.⁴ At each annual review, KRX selects 200 of the largest and most liquid Korean stocks based primarily on average market capitalization and value of average daily trading volume over the year ending on April 30.⁵ Based on data supplied

information on the FSC is available on its English language website, <<http://www.fsc.go.kr/eng/>>

³ See electronic mail from Philip McBride Johnson, Esq., Skadden, Arps, Slate, Meagher & Flom LLP to David R. Merrill, Deputy General Counsel, CFTC, dated March 13, 2006. Amendments to the Act on Real Name Financial Transactions and Guarantee of Secrecy passed by the Korean National Assembly on March 2, 2006, provided this authorization. Because KRX could not confirm prior to that time that Korean Law would permit the FSC to share transaction information with the Commission, KRX had requested that this Office suspend its consideration of its application on June 2, 2005. See letter from Philip McBride Johnson, Skadden, Arps, Slate, Meagher & Flom LLP to Patrick J. McCarty, General Counsel, CFTC, dated June 2, 2005. After passage of the aforementioned amendments, KRX requested that this Office resume its consideration of KRX’s application. See electronic mail from Mr. Johnson to Mr. Merrill, dated March 13, 2006.

⁴ See electronic mail from Philip McBride Johnson, Esq., Skadden, Arps, Slate, Meagher & Flom LLP to Julian E. Hammar, Assistant General Counsel, CFTC, dated March 14, 2008 (Attachment 1, *KOSPI 200 Calculation Method*). Trading restrictions exist for members of the Stock Price Index Policy Committee, as well as KRX employees involved in Index decisions. See letter from Philip McBride Johnson, Esq., Skadden, Arps, Slate, Meagher & Flom LLP to Patrick J. McCarty, General Counsel, CFTC, dated July 14, 2004, at 3, and letter from Philip McBride Johnson, Esq., Skadden, Arps, Slate, Meagher & Flom LLP to Patrick J. McCarty, General Counsel, CFTC, dated June 10, 2004, at 3.

⁵ See electronic mail from Mr. Johnson to Mr. Hammar, dated March 14, 2008 (Attachment 1, *KOSPI 200 Calculation Method*). KRX also gives priority for inclusion in the Index to non-manufacturing companies over manufacturing companies. For each non-manufacturing group,

by KRX, the free-float adjusted market capitalization of the KOSPI 200 was approximately U.S.\$ 495.4 billion as of March 4, 2008.⁶ The largest single security by weight represented 10.25%, and the five most heavily-weighted securities represented 27.67% of the Index.⁷ The securities comprising the lowest 25% of the KOSPI 200 had a six-month aggregate dollar value of average daily trading volume in excess of U.S.\$ 30 million: approximately U.S.\$ 2 billion, for the six-month period ending September 30, 2007.⁸ The Index is calculated in real time and is disseminated by electronic means through major data vendors, including Bloomberg and Reuters.⁹

KRX's futures contract on the KOSPI 200 began trading on May 3, 1996 on the KSE, and subsequently transferred to KOFEX on January 2, 2004. The contract currently is listed and traded on KRX's Futures Market Division and provides for cash settlement.¹⁰ Prices for the contract are quoted in Index points, with each Index point equal to 500,000 Korean won per contract. The minimum tick is 0.05 Index point or 25,000 Korean won per contract. KRX lists for trading the four nearest months of the March quarterly cycle (March, June, September and December). The last trading day of the contract is the second Thursday of the contract month.

KRX considers for inclusion in the Index the largest stocks that collectively account for no more than 70% of the total market capitalization of that industry group. However, to be eligible for inclusion, a stock also must be among the top 85% in terms of value of average daily trading volume. KRX then repeats this process for manufacturing industry groups. A stock that is passed over for consideration may be selected depending upon its significance as long as it is among the largest 50 stocks by average market capitalization. KRX may exclude a company that has less than a 10% free-float ratio. An existing component remains in the Index as long as its ranking in its industry group has not fallen by more than 10%, and new companies are added to the KOSPI 200 if they are within the largest 90% of all constituents in the corresponding industry group. In addition to the annual review, KRX revises the Index on an on-going basis in response to corporate events such as mergers, de-listings, etc. Notice of a change in the composition of the Index is made two weeks prior to implementation, after trading hours.

⁶ See *id.* (Attachment 2 Spreadsheet).

⁷ See *id.* and electronic mail from Philip McBride Johnson, Esq., Skadden, Arps, Slate, Meagher & Flom LLP to Julian E. Hammar, Assistant General Counsel, CFTC, dated October 24, 2007 (Attachment 1 Spreadsheet).

⁸ *Id.*

⁹ See letter from Mr. Johnson to Mr. McCarty, dated June 10, 2004, at 2.

¹⁰ Contract specifications for KRX's KOSPI 200 futures contract are available on the KRX English language website, <<http://eng.krx.co.kr/index.html>>.

Final settlement occurs on the business day following the last trading day. The final cash settlement price for the contract is the closing Index level on the last trading day.¹¹

The Commodity Exchange Act (“CEA”),¹² as amended by the Commodity Futures Modernization Act of 2000 (“CFMA”),¹³ 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,¹⁴ with the exception of security futures products,¹⁵ over which the Commission shares jurisdiction with the Securities and Exchange Commission (“SEC”).¹⁶ Thus, the Commission’s jurisdiction remains exclusive with regard to a futures contract on a group or index of securities that is broad-based pursuant to CEA Section 1a(25).¹⁷

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).¹⁸ 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”):

¹¹ If there is no closing Index level on the last trading day, KRX uses a special settlement price calculated using the opening prices of KOSPI 200 component stocks on the business day following the last trading day. *See* letter from Mr. Johnson to Mr. McCarty, dated June 10, 2004, Appendix E.

¹² 7 U.S.C. § 1 *et seq.*

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

¹⁴ *See* CEA Section 2(a)(1)(C)(ii).

¹⁵ A security futures product is 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).

¹⁶ *See* CEA Section 2(a)(1)(D).

¹⁷ *See* CEA Section 2(a)(1)(C)(ii).

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

- (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.¹⁹

While Section 2(a)(1)(C)(ii) provides that no 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 foreign boards of trade do not seek designation as a contract market or registration as a DTEF to trade those products.²⁰

Accordingly, Commission staff has examined the KOSPI 200 and KRX'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

¹⁹ 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).

²⁰ 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.

forth in the letter, attachments, facsimiles and electronic mail cited above, we have determined that the KOSPI 200 and KRX's futures contract based thereon conform to these requirements.²¹

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 of the component securities in the KOSPI 200 are listed and traded on KRX's securities market division. The KRX's Market Oversight Commission is authorized to perform cross market surveillance between KRX's securities and futures market divisions.²² Accordingly, KRX should have access to information with respect to the securities underlying the KOSPI 200 necessary to detect and deter manipulation. In the event that KRX is unable to obtain access to adequate surveillance data in this regard, or is unable through the FSC to 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 enforcement action to the Commission based on Sections 2(a)(1)(C)(iv), 4(a), or 12(e) of the CEA, as amended, if KRX's futures contract based on the KOSPI 200 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 KRX with all regulatory requirements imposed by the FSC, and the applicable laws and regulations of Korea. 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.

²¹ In making this determination, Commission staff has concluded that the KOSPI 200 does not have any of the elements of a narrow-based security index as enumerated in CEA Section 1a(25)(A). Accordingly, the Index would not be a narrow-based security index if traded on a designated contract market or DTEF.

²² See KRX Market Surveillance Regulation (Jan. 24, 2005).

²³ KRX has represented that it is not aware of any legal impediment in Korea to sharing market surveillance and related information with its regulator, the FSC, and has agreed to do so in relation to any market data requested by the Commission. See letter from Mr. Johnson to Mr. McCarty, dated June 10, 2004, at 3. KRX also is a signatory to the International Information Sharing Memorandum of Understanding and Agreement signed on March 15, 1996, at Boca Raton, Florida. The FSC has confirmed that, according to the Korean Act on Real Name Financial Transactions and Guarantee of Secrecy, as amended, it may supply transaction information to a foreign financial regulatory authority upon receiving a request for such information. Moreover, the FSC has confirmed that, in the event that the CFTC requests transaction information, including customer identification information, for market oversight, consumer protection, and other relevant purposes, the FSC is willing and able to provide such information to the CFTC. See letter from Young Man Hong, Director-General, Capital Market Policy Office, FSC to Terry S. Arbit, General Counsel, CFTC, dated August 5, 2008.

The relief granted herein allows KRX's futures contract on the KOSPI 200 to be offered and sold in the United States. The offer and sale of this contract in the U.S. is, of course, subject to Part 30 of the Commission's regulations, which governs the offer and sale of all foreign futures and foreign option contracts in the U.S.²⁴

Sincerely,

Terry S. Arbit
General Counsel

²⁴ See 17 C.F.R. Part 30. We note that, although U.S. customers may be permitted under the CEA to buy or sell a particular product, the law of a particular foreign jurisdiction may not allow a U.S. futures commission merchant to become a clearing member on the foreign exchange or to establish an omnibus account with a clearing member on that exchange. In these circumstances, a U.S. customer would not be able to buy or sell the foreign product, unless appropriate relief has been granted to the foreign regulator or the exchange pursuant to CFTC Regulation 30.10, 17 C.F.R. § 30.10.