



DIVISION OF  
MARKET REGULATION

UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
WASHINGTON, D.C. 20549

July 23, 1999

Nancy Jacklin, Esq.  
Clifford Chance  
One New York Plaza  
New York, NY 10004

Re: Osaka Securities Exchange--Equity Options and Options on the Nikkei 225 Index and the Nikkei 300 Index

Dear Ms. Jacklin:

In your letter, dated May 25, 1999, on behalf of the Osaka Securities Exchange ("OSE"), you request advice that the Division of Market Regulation ("Division") will not recommend enforcement action to the Securities and Exchange Commission ("Commission") against (1) the OSE, OSE Regular Members, or OSE Special Participants (together, "OSE Regular Members and Special Participants")<sup>1</sup> under Section 5 of the Securities Exchange Act of 1934 ("Exchange Act") by reason of the OSE not registering as a national securities exchange under Section 6 of the Exchange Act; (2) the OSE under Section 17A of the Exchange Act, by reason of the OSE not registering thereunder as a clearing agency; or (3) against the OSE, OSE Regular Members or Special Participants under Section 15(a) of the Exchange Act, by reason of their not registering under Section 15(b) of the Exchange Act as broker-dealers, if the OSE and OSE Regular Members and Special Participants act as described below to familiarize certain registered broker-dealers and large financial institutions in the United States with the OSE and the equity options and Nikkei 225 Index options and Nikkei 300 Index options traded on the OSE. The relief you seek is similar to that previously granted by the Division to other non-U.S. exchanges.<sup>2</sup>

<sup>1</sup> As discussed more fully below, OSE Regular Members are securities companies principally engaged in all trading activities on the cash, futures, and options markets of the OSE. Special Participants are securities companies that may participate solely in the futures and options markets of the OSE.

<sup>2</sup> See e.g., Letter from Robert L.D. Colby, Deputy Director, Division, Commission, to Jane Kang Thorpe, Orrick, Herrington & Sutcliffe, dated October 26, 1998 (regarding STOXX 50 Index and EURO STOXX 50 Index options traded on MONEP); Letter from Robert L.D. Colby, Deputy Director, Division, Commission, to Wesley G. Nissen, Katten Muchin & Zavis, dated September 1, 1998 (regarding equity and index options traded on the Mercato Italiano dei Derivati); Letter from Robert L.D. Colby, Deputy Director, Division, Commission, to Nancy Jacklin, Clifford

We understand the facts to be as follows:

The OSE was established on April 1, 1949, as a nonprofit membership organization under the Japanese Securities and Exchange Law. The OSE is licensed as a stock exchange, and both the OSE and OSE Regular Members and Special Participants are subject to regulation by the Ministry of Finance ("MOF") and the Financial Supervision Agency ("FSA").<sup>3</sup> The membership of the OSE consists of securities companies directly and principally engaged in trading at the market facility established by the OSE. The OSE's offices, facilities, and operations are located in Osaka, Japan. The OSE is subject to Japanese law, and is not registered under the Exchange Act in any capacity.

Membership in the OSE is limited to domestic securities companies or the Japanese branches of foreign securities companies licensed by the MOF or, after December 1, 1998, registered with the FSA. Membership in the OSE consists of OSE Regular Members, which are securities companies principally engaged in all trading activities on the cash, futures, and options markets of the OSE. In addition to OSE Regular Members, two types of Special Participants may participate solely in the futures and options markets of the OSE: (1) Special Participants in Equity Options, which are qualified to trade only equity options on the OSE; and (2) Special Participants in Stock Index Futures and Options, which are qualified to trade only stock index futures and options on the OSE (together, the "Special Participants"). Special Participants are limited to non-member domestic securities companies or the Japanese branches of foreign securities companies licensed by the MOF or, after December 1, 1998, registered with the FSA.

The OSE was the first securities exchange to trade equity derivatives in Japan, and currently is the largest equity derivatives exchange in Japan, as measured by trading volume and trading value. The OSE provides a marketplace for transactions in securities, equity options, stock index futures and options, securities investment trust beneficiary certificates, and subscription warrants. In 1989, the OSE began trading options on the Nikkei Stock Average ("Nikkei 225 Index Options"), an average stock price index comprised of 225 actively-traded stocks listed on the First Section of the Tokyo Stock Exchange ("TSE").<sup>4</sup> In 1994, the OSE began trading options on the Nikkei Stock Index

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Chance, dated March 6, 1996 (regarding FLEX options traded on the London International Financial Futures and Options Exchange ("LIFFE")); Letter from Robert Colby, Deputy Director, Division, Commission, to Phillip McBride Johnson, Skadden, Arps, Slate, Meagher & Flom (regarding equity and index options traded on the Hong Kong Futures Exchange); and Letter from William H. Heyman, Director, Division, Commission, to Gary Lynch, Davis, Polk & Wardwell, dated May 1, 1992 (regarding equity and index options traded on the LIFFE).

<sup>3</sup> The FSA was established on June 22, 1998, as a result of a reorganization of the MOF.

<sup>4</sup> Domestic stocks listed on the TSE are assigned to either the First or Second Section of the TSE. In general, newly-listed domestic stocks are assigned to the Second Section. Stocks are moved to

300 ("Nikkei 300 Index Options," and, with the Nikkei 225 Index Options, the "Index Options"), a market value-weighted index comprised of 300 actively-traded stocks listed on the First Section of the TSE.<sup>5</sup> The Nikkei 225 Index and the Nikkei 300 Index are computed and published by the Nikon Keizai Shimbun, Inc.

In 1997, the OSE began trading options on individual stocks that are listed and traded on at least one of the eight stock exchanges in Japan ("Equity Options"). The OSE currently lists Equity Option contracts on the stocks of approximately 100 leading Japanese companies. The OSE selects securities for individual options trading from stocks listed on the First Section of the OSE, TSE, or Nagoya Stock Exchange, or from stocks listed on other stock exchanges in Japan, which meet the following criteria:

- (1) the stock has 500 million or more shares listed at the end of the last fiscal year;  
or
- (2) for a stock with over 100 million but less than 500 million shares listed, the stock has monthly average trading volume of two million shares or more during the last year on all stock exchanges in Japan.

All Equity Options and Index Options traded on the OSE feature European-style exercise (i.e., they are exercisable only on their expiration date). Prices on the OSE for Equity Options and Index Options are quoted in Japanese yen, and all Equity Options and Index Options are bought and sold in Japanese yen. Equity Options and Index Options are not fungible or interchangeable with options that are traded on any other market. Equity Options and Index Options registered with the OSE by an OSE Regular Member or Special Participant can be closed only on the OSE or exercised by the OSE Regular Member or Special Participant giving an exercise notice to the OSE.

The OSE conducts trading in Equity Options and Index Options through the Computer-Assisted Trading System. OSE Regular Members and Special Participants enter orders in the Computer-Assisted Trading System from terminals located in their offices. Orders are registered into central processing equipment, where they are computed and classified according to each issue. The orders are matched and executed automatically through the Computer-Assisted Trading System.

After a trade is executed, the printers of the OSE Regular Members or Special Participants involved in the trade immediately print contract execution notices.

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the more actively-traded First Section only after they meet certain criteria based on the number of shares listed, the number of shareholders, average monthly trading volume, and dividend record and prospects. Stocks in the First Section that fall below these criteria are transferred to the Second Section.

<sup>5</sup> The OSE also trades futures and options on the High-Technology Index, the Financial Index, and the Consumer Index. OSE Regular Members and Special Participants will be advised that options contracts on these indexes may not be executed with or for a person located in the U.S.

Simultaneously, the contract information is announced automatically through the OSE's market information systems, the Market Information Transmission System and the Electronic Market Information System. OSE officials monitor all trading activity through control terminal equipment.

Currently, for Equity Options and Index Options trading, the OSE does not provide direct electronic access to the OSE to persons located in the United States. The OSE represents that it will not make Equity Options or Index Options trading accessible in this fashion absent express approval from the Commission.<sup>6</sup>

The OSE Clearing Administration Department ("Clearing Department"), a department within the OSE, administers the clearance and settlement of transactions executed on the OSE. In general, the Clearing Department: (1) provides a framework of rules and systems; (2) administers the collection and payment of premiums and margins; (3) organizes and maintains guarantee funds for contract performance and client compensation; and (4) substitutes a member in the event of another member's default. The Clearing Department does not become a counterparty to Equity Option or Index Option contracts on registration. Responsibilities on Equity Option and Index Option contracts remain with the OSE Regular Member or Special Participant that executed the transaction. OSE Regular Members and Special Participants are responsible for the clearing and settlement of options transactions that they execute for customers, and they may not entrust the clearing of their trades to another OSE Regular Member or Special Participant.

The settlement of an exercised Equity Option is made by the delivery of the underlying stock at the exercise price. Under Japan's Central Securities Depository System, transactions in shares are settled by book entry, with stock certificates held in custody by the Japan Securities Depository Center. Settlements of stock and cash are made through procedures whereby the OSE receives the stock and/or cash on behalf of the relevant OSE Regular Member or Special Participant. Settlement must be made on the fourth business day following the day of exercise (T+4).

The settlement of Index Options is made by payment of the cash difference between the exercise price and the option settlement price.<sup>7</sup> Settlement must be made on the next business day following the exercise date (T+1), although an OSE Regular Member or Special Participant may allow a non-resident customer to delay settlement until the second business day following the exercise date (T+2).

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<sup>6</sup> Telephone conversation between Yvonne Fraticelli, Special Counsel, Division, Commission, and Tina Woo, Clifford Chance, on June 25, 1999.

<sup>7</sup> Except on the day following the last trading day of each exercise month, the option settlement price is the closing Nikkei 300 Index value for the day or the closing Nikkei 225 Index value for the day. On the day following the last trading day of each expiration month, the option settlement price is a special settlement price determined pursuant to the rules of the OSE.

Each OSE Regular Member and Special Participant is required to deposit and maintain margin with the OSE in respect of each option for which it represents the writer. The selling customer must deposit margin with the OSE Regular Member or Special Participant, and the selling OSE Regular Member or Special Participant must deposit margin with the OSE. Each selling customer and each selling OSE Regular Member or Special Participant must maintain its deposited margin up to at least the amount (or more) calculated on a net position basis according to the margin calculation formulae prescribed by the OSE. When a shortfall occurs, a customer must deposit additional margin with the OSE Regular Member or Special Participant on the business day following the day on which the shortage arose (T+1) by the specific hour designated by the OSE Regular Member or Special Participant. However, an OSE Regular Member or Special Participant may allow a non-resident customer to delay its margin deposit until the second business day following the day on which the shortage arose (T+2). An OSE Regular Member or Special Participant must deposit with the OSE margin equivalent in value to the shortage in its own account or a customer's account by 12:00 p.m. on the next business day (or by 11:00 a.m. on a half trading day)<sup>8</sup> following the day on which the shortage arose (T+1).

OSE Regular Members and Special Participants are required to maintain monies and securities deposited as customers' margin separately from their own monies and securities. If a customer defaults on its obligations on an option contract, the OSE Regular Member or Special Participant through whom it has acted may settle any unsettled position by conducting an offsetting transaction, exercising the option, or buying/selling the underlying stock, as appropriate, for the customer's account. If the OSE Regular Member or Special Participant suffers a loss, it may appropriate the customer's monies and securities held by the OSE Regular Member or Special Participant as compensation. If an OSE Regular Member or Special Participant is or is expected to be in default, the OSE may suspend the OSE Regular Member's or Special Participant's membership or qualification for trading and its receipt of any monies or securities through the OSE and can appropriate such assets for the settlement of open positions.

In addition to each OSE Regular Member's subscription, which contributes to the equity of the OSE, and the OSE's rights to appropriate a defaulting OSE Regular Member's or Special Participant's rights to monies or securities held or transferred through the OSE, there are a number of reserves and funds established to meet losses arising from an OSE Regular Member's or Special Participant's default. In particular, the OSE establishes and maintains a Membership Guarantee Deposit ("MGD") from OSE Regular Members and Special Participants to ensure settlement of customers' transactions. The Japanese Securities and Exchange Law provides that in the event that an OSE Regular Member or Special Participant defaults on its obligations to a customer who orders and executes trades through that OSE Regular Member or Special Participant, the customer has the right to receive payment for its losses in preference to any OSE Regular

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<sup>8</sup> Half-trading days occur on the OSE on the last business day of the year (usually December 30) and on the first business day of the year.

Member or Special Participant from the OSE Regular Member's or Special Participant's MGD. Furthermore, if a defaulting OSE Regular Member or Special Participant damages other OSE Regular Members or Special Participants, the non-defaulting OSE Regular Members or Special Participants also have the right to receive payment for damages from the defaulter's MGD after the defaulter's customers are satisfied.

To meet any further losses, the OSE maintains the Default Compensation Fund for Equity Options Trading (the "Equity Options Fund") and the Default Compensation Reserve for Futures and Options Trading (the "Futures and Options Reserve"). OSE Regular Members and Special Participants are required to make special deposits with the OSE in cash or securities acceptable to the OSE ("Special Deposits") for the Equity Options Fund and/or to make payments to the Futures and Options Reserve if they trade in Equity and/or Index Options, respectively.

If losses arise due to a default by an OSE Regular Member or Special Participant on an Equity Options contract, the OSE appropriates the Special Deposit of the defaulting OSE Regular Member or Special Participant to cover the resulting losses suffered by non-defaulting OSE Regular Members and Special Participants. If there is a loss beyond the Special Deposit of the defaulter, the OSE can appropriate the Special Deposit of non-defaulting OSE Regular Members or Special Participants to cover the losses.

In the event that there are losses after the appropriation of the Special Deposits, the OSE can collect extraordinary special dues from non-defaulting OSE Regular Members and Special Participants after a resolution passed by a two-thirds vote of the members present at a meeting of the Board of Governors of the OSE. The special dues would be credited to the Equity Options Fund and used to cover the remaining losses.

The OSE would follow similar but not identical procedures for Index Options. Specifically, if an OSE Regular Member or Special Participant defaults on transactions in Index Options, the amounts held in the Futures and Options Reserve can be used to cover any losses to non-defaulting OSE Regular Members or Special Participants. As in the case of Equity Options, any further losses can be covered, if approved by a resolution passed by a two-thirds vote of the members present at a meeting of the Board of Governors of the OSE, by a collection of additional "Special Dues for Futures and Options Trading."

The OSE wishes to familiarize certain registered broker-dealers and large financial institutions in the United States with Equity Options and Index Options traded on the OSE. To do this, the OSE proposes to take the limited steps described below with respect only to "Eligible Broker-Dealers" and "Eligible Institutions." To be Eligible, each such entity must meet the following standards:

- (a) it must be a "qualified institutional buyer" as defined in Rule 144A(a)(1) under the Securities Act of 1933 ("Rule 144A" and the "Securities Act," respectively), or

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an international organization excluded from the definition of "U.S. person" in Rule 902(k)(2)(vi) of Regulation S under the Securities Act, and

(b) it must have had prior actual experience with traded options in the United States options market (and, therefore, would have received the disclosure document for U.S. standardized options called for by Rule 9b-1 under the Exchange Act).

The OSE will require OSE Regular Members and Special Participants to take reasonable steps to assure themselves, before effecting any transaction in Equity Options or Index Options for or with a customer located in the United States, that: (1) the customer is an Eligible Broker-Dealer or an Eligible Institution; (2) the customer is acting for its own account or the account of another Eligible Broker-Dealer or Eligible Institution or the managed account of a non-U.S. person (within the meaning of Rule 902(k)(2)(vi) of Regulation S under the Securities Act); and (3) the customer has received the OSE Disclosure Document described below. The OSE will advise OSE Regular Members and Special Participants that it has been advised that, under U.S. law, OSE Regular Members and Special Participants which are not U.S. registered broker-dealers may deal with Eligible Institutions only in accordance with Rule 15a-6 under the Exchange Act, principally through U.S. registered broker-dealers as provided in such Rule.

You represent that the OSE will institute rules requiring OSE Regular Members and Special Participants to furnish Eligible Broker-Dealers and Eligible Institutions with an OSE Disclosure Document before accepting an order from that Eligible Broker-Dealer or Eligible Institution to purchase or sell Equity Options or Index Options. The OSE's rules also will require that each OSE Regular Member and Special Participant obtain written representations from any Eligible Broker-Dealer or Eligible Institution, signed by an appropriate officer of the Eligible Broker-Dealer or Eligible Institution, to the following effect:

1. it is an Eligible Broker-Dealer or Eligible Institution, and as such it (i) owns and invests on a discretionary basis a specified amount of eligible securities sufficient for it to be a qualified institutional buyer under Rule 144A under the Securities Act (and if a bank, S&L, or other thrift institution, has net worth meeting the requirements of Rule 144A under the Securities Act), and (ii) has had prior actual experience in the U.S. standardized options markets and as a result thereof has received the options disclosure document entitled "Characteristics and Risks of Standardized Options," ("Options Disclosure Document," or "ODD") that is prepared by the Options Clearing Corporation and the U.S. options exchanges;

2. it has received the OSE Disclosure Document;

3. its transactions in Equity Options and Index Options will be for its own account or for the account of another Eligible Broker-Dealer or Eligible Institution or for the

managed account of a non-U.S. person within the meaning of Rule 902(k)(2)(vi) of Regulation S under the Securities Act;

4. it will not transfer any interest or participation in an Equity Option or Index Option it has purchased or written to any other U.S. person, or to any person in the United States, that is not an Eligible Broker-Dealer or Eligible Institution;

5. it will cause any disposition of an Equity Option or Index Option it has purchased or written to be effected only on the OSE and to be settled on the OSE in Osaka, and it understands that any required payments for premium settlement, exercise or closing of any Equity Option or Index Option with respect to which it has a contract with the OSE Regular Member or Special Participant must be made in Osaka and in Japanese yen. It also understands that, if in relation to an Equity Option or Index Option, it has a contract as a writer with the OSE Regular Member or Special Participant, margin must be provided to the OSE Regular Member or Special Participant, and maintained, measured and deposited in Japanese yen or other collateral approved by the OSE;

6. if it is an Eligible Broker-Dealer or Eligible Institution acting on behalf of another Eligible Broker-Dealer or Eligible Institution that is not a managed account, it has obtained from the other a written representation to the same effect as set forth in (1) through (5) above and will provide it to the OSE Regular Member or Special Participant upon demand; and

7. it will notify the OSE Regular Member or Special Participant of any change in the foregoing representations prior to placing any future order, and the foregoing representations will be deemed to be made with respect to each order it gives to the OSE Regular Member or Special Participant.

The OSE Disclosure Document, in the form submitted to and reviewed by the Division, will be provided only to Eligible Broker-Dealers and Eligible Institutions. The OSE Disclosure Document provides an overview of the OSE, with attention to significant differences from standardized options in the U.S. domestic options market, as well as special factors relevant to U.S. entities transacting in Equity Options and Index Options.

The OSE will not engage in any general advertisement concerning Equity Options or Index Options in the United States.

The OSE will appoint certain officers located in Osaka to act as the OSE's representatives in the United States ("OSE Representatives"). OSE Representatives are available to respond to inquiries concerning the OSE from Eligible Broker-Dealers and Eligible Institutions. Any OSE Representative may make personal calls on and correspond or otherwise communicate with entities whom such OSE Representative reasonably believes to be Eligible Broker-Dealers and Eligible Institutions to familiarize them with the existence and operations of the OSE. Any Eligible Broker-Dealer or Eligible Institution will be provided with the OSE Disclosure Document upon its first visit, communication or

inquiry.<sup>9</sup> OSE Representatives located in Osaka will maintain a reasonable supply of that document, and of the most recently published annual reports of the OSE, prepared in English, to respond to requests therefor from Eligible Broker-Dealers and Eligible Institutions. OSE Representatives also may participate in programs and seminars in the United States. OSE Representatives will be prohibited from: (1) giving investment advice and making any recommendations with respect to specific Equity Options or Index Options to Eligible Broker-Dealers or Eligible Institutions; (2) soliciting, taking, or directing orders from Eligible Broker-Dealers or Eligible Institutions; and (3) recommending or referring particular OSE Regular Members or Special Participants to Eligible Broker-Dealers or Eligible Institutions. If requested by an Eligible Broker-Dealer or Eligible Institution, an OSE Representative may make available to the requester a list of all OSE Regular Members and Special Participants and any registered U.S. broker-dealer affiliates of such OSE Regular Members or Special Participants.

You represent that the OSE will continue to be an organized exchange operating and regulated outside the U.S., and that making OSE Equity Options and Index Options known to a particular, sophisticated segment of the U.S. financial community will not substantially alter this fact. You also represent that the OSE will take careful limitations to assure compliance with applicable U.S. securities laws, and that the OSE will continue to establish further limitations, as necessary, to assure continued compliance with applicable U.S. securities laws. You further represent that making information concerning the OSE available in the United States as described in this letter will serve to increase, in a responsible manner, information concerning an important and growing marketplace in Japan that will be of substantial benefit to appropriate U.S. professionals and institutions.

Finally, you also ask the Division to confirm (1) that the furnishing of the OSE Disclosure Document by an OSE Representative, by an OSE Regular Member or Special Participant or by an Eligible Broker-Dealer, in each case, to an Eligible Broker-Dealer or Eligible Institution will satisfy the obligation under Rule 9b-1(d) of the Exchange Act to furnish an options disclosure document before accepting an order from a customer to purchase or sell an Equity Option or Index Option, and (2) that neither the OSE Representative's furnishing of the OSE Disclosure Document to an Eligible Broker-Dealer or Eligible Institution, nor an OSE Regular Member's or Special Participant's furnishing of an OSE Disclosure Document to an Eligible Broker-Dealer or, in response to an unsolicited inquiry to an Eligible Institution, will constitute either solicitation or the provision of a research report as those terms are used in Rule 15a-6(a) under the Exchange Act.

**Response:**

Based on the facts and representations set forth above, the Division will not recommend enforcement action to the Commission against the OSE or OSE Regular

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<sup>9</sup> If the first communication is by telephone, the OSE Disclosure Document will be mailed within one business day of the communication.

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Members or Special Participants under Section 15(a) of the Exchange Act if the OSE or OSE Regular Members or Special Participants act as you describe to familiarize Eligible Broker-Dealers and Eligible Institutions in the United States with Equity Options and Index Options without the OSE or OSE Regular Members or Special Participants registering with the Commission as broker-dealers under Section 15(b) of the Exchange Act. Also, the Division will not recommend enforcement action to the Commission against the OSE or OSE Regular Members or Special Participants under Section 15(a) of the Exchange Act if, solely in connection with the satisfaction of obligations under Exchange Act Rule 9b-1(d) and under the limited circumstances set forth above, (1) an OSE Representative, an OSE Regular Member or Special Participant or an Eligible Broker-Dealer provides the OSE Disclosure Document to an Eligible Broker-Dealer and the OSE Regular Member or Special Participant effects transactions in Equity Options or Index Options with or for that Eligible Broker-Dealer pursuant to Rule 15a-6(a)(4) under the Exchange Act, or (2) an OSE Representative furnishes an OSE Disclosure Document to an Eligible Institution, or an OSE Regular Member or Special Participant furnishes an OSE Disclosure Document to an Eligible Institution in response to an otherwise unsolicited inquiry concerning Equity Options or Index Options, and the OSE Regular Member or Special Participant effects transactions in Equity Options or Index Options with or for that Eligible Institution pursuant to Rule 15a-6(a)(1) under the Exchange Act.

Based on the foregoing, the Division also will not recommend that the Commission take enforcement action against the OSE under Section 17A of the Exchange Act if it operates solely in the manner described above for Equity Options and Index Options without registering with the Commission as a clearing agency. In addition, the Division will not recommend that the Commission take enforcement action against the OSE under Section 5 of the Exchange Act if the OSE operates solely in the manner described above with respect to Equity Options and Index Options without registering with the Commission as a national securities exchange under Section 6 of the Exchange Act.

Finally, the Division has reviewed the OSE Disclosure Document. Based on our review of the OSE Disclosure Document, the Division wishes to advise you that it will not recommend that the Commission take enforcement action against an Eligible Broker-Dealer, OSE Representative, or OSE Regular Member or Special Participant pursuant to Rule 9b-1(d) under the Exchange Act if the Eligible Broker-Dealer, OSE Representative or OSE Regular Member or Special Participant furnishes the OSE Disclosure Document to an Eligible Broker-Dealer or Eligible Institution before the Eligible Broker-Dealer or Eligible Institution effects a transaction in Equity Options or Index Options, subject to the following conditions:

- (1) the Eligible Broker-Dealer or Eligible Institution previously has received the ODD;
- (2) the OSE requires that OSE Regular Members and Special Participants, before effecting a transaction with or for an Eligible Broker-Dealer or Eligible Institution in Equity Options or Index Options, determine as described above, that the Eligible

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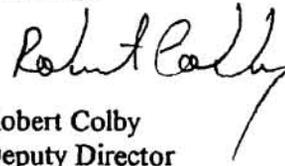
Broker-Dealer or Eligible Institution has received the ODD and the OSE Disclosure Document and maintains a record of that determination; and

(3) the OSE furnishes the Division, at least 30 days prior to the date definitive copies are furnished to Eligible Broker-Dealers or Eligible Institutions, with a copy of any amendment made to the OSE Disclosure Document because the information contained in that document becomes or will become materially inaccurate or incomplete, or because there is or will be an omission of material information necessary to ensure that the document is not misleading.

These positions of the Division concern enforcement action only and do not represent conclusions on the applicability of statutory or regulatory provisions of the federal securities laws. The Division has taken these positions based, in part, on the fact that the Commission has entered into a Memorandum of Understanding with the MOF that provides a framework for mutual assistance in investigating regulatory matters,<sup>10</sup> and that foreign broker-dealers, including OSE Regular Members and Special Participants, electing to deal with U.S. institutional investors pursuant to Rule 15a-6(a)(3) under the Exchange Act are required to provide directly to the Commission, upon request, information, documents, testimony, and assistance in taking evidence of persons that relate to transactions pursuant to Rule 15a-6(a)(3) under the Exchange Act. Moreover, these positions are based on the understanding that under Japanese law only members licensed or registered by the competent Japanese authorities may have direct access to the OSE, which is licensed as a stock exchange and subject to regulation by the FSA. Finally, these positions are based on your representations that the OSE currently does not provide direct electronic access for Equity Option and Index Option trading to persons located in the United States, and that the OSE will not make Equity Options or Index Options accessible in this fashion absent express approval from the Commission.

The positions of the Division in this letter are based on the representations that you have made; any different facts or conditions might require a different response, and these positions are subject to modification or revocation if the facts and representations set forth above are altered.

Sincerely,



Robert Colby  
Deputy Director

<sup>10</sup> Memorandum of the United States Securities and Exchange Commission and the Securities Bureau of the Japanese Ministry of Finance on Sharing Information (May 23, 1986).

# CLIFFORD CHANCE

ONE NEW YORK PLAZA NEW YORK NEW YORK 10004  
TELEPHONE (212) 709 4200

TELEX 429391 LEGIS UI FAX (212) 709 4242 WWW: <http://www.cliffordchance.com>

AMSTERDAM BANGKOK BARCELONA BRUSSELS BUDAPEST DUBAI DUSSELDORF FRANKFURT HANOI HO CHI MINH CITY HONG KONG LONDON MADRID  
MOSCOW NEW YORK PARIS PRAGUE SAO PAULO SHANGHAI SINGAPORE TOKYO WARSAW WASHINGTON DC ASSOCIATED OFFICES MILAN PADUA ROME

YOUR REFERENCE

IN REPLY PLEASE QUOTE

DATE

May 25, 1999

Division of Market Regulation  
Securities and Exchange Commission  
450 5th Street, N.W.  
Washington, D.C. 20549

Attention: Robert L.D. Colby, Deputy Director

**Re: Trading of Equity and Stock Index Options on the Osaka Securities Exchange**

Dear Sirs:

On behalf of the Osaka Securities Exchange (the "OSE" or the "Exchange"), we request your advice that, based on the circumstances stated in this letter, and in view of the relief granted by the Division of Market Regulation (the "Division") to the Mercato Italiano dei Derivati,<sup>1</sup> the Société de Compensation des Marchés Conditionnels,<sup>2</sup> the Hong Kong Futures Exchange Limited<sup>3</sup> and the London International Financial Futures Exchange and the London Clearing House Limited<sup>4</sup> (collectively, the "Options No-Action Letters"), the Division will not recommend enforcement action to the Securities and Exchange Commission (the "Commission") against the OSE or OSE members under Section 5 of the Securities Exchange Act of 1934 (the "Exchange Act"), by reason of the OSE not registering under Section 6 of the Exchange Act, against the OSE under Section 17A of the Exchange Act, or against the OSE or OSE members under Section 15(a) of the Exchange Act, if the OSE and OSE members act as described below to familiarize certain registered broker-dealers and large financial institutions in the United States with the OSE and the equity and index options traded on the OSE, without the OSE registering with the Commission as a national securities exchange, without the OSE registering with the Commission as a clearing agency, and without the OSE or OSE members registering with the Commission as broker-dealers.

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<sup>1</sup> See Mercato Italiano dei Derivati, available September 1, 1998.

<sup>2</sup> See Société de Compensation des Marchés Conditionnels, available June 17, 1996.

<sup>3</sup> See Hong Kong Futures Exchange Limited -- Hang Seng Index Options, available September 26, 1995.

<sup>4</sup> See London International Financial Futures Exchange, available May 1, 1992, and London International Financial Futures Exchange, available March 6, 1996.

## CLIFFORD CHANCE

The OSE was established on April 1, 1949, as a nonprofit membership organization under the Japanese Securities and Exchange Law. The OSE is licensed as a stock exchange and subject to regulation by the Ministry of Finance (the "MOF") and the Financial Supervision Agency (the "FSA") which was newly established on June 22, 1998, as a result of a reorganization of the MOF. The OSE's offices, facilities, and operations are located in Osaka, Japan. The OSE is subject to Japanese law, and is not registered under the Exchange Act in any capacity.

The OSE was the first securities exchange to trade equity derivatives in Japan, and currently is the largest equity derivatives exchange in Japan. In June 1987, the OSE began trading futures, and in June 1989, the OSE began trading stock index options. Currently, in addition to the new equity sector index futures and options which the OSE introduced on June 15, 1998, stock index futures, equity options ("**Equity Options**") and stock index options ("**Index Options**") are traded on the OSE. Equity Options contracts are listed on approximately 100 equity securities of leading Japanese companies. All underlying securities for Equity Options are stocks listed and traded on at least one of the eight stock exchanges in Japan. Index Options are based on the Nikkei Stock Average (the "**Nikkei 225**"), an average stock price index, and the Nikkei Stock Index 300 (the "**Nikkei 300**"), a market-value weighted index. The Nikkei 225 and the Nikkei 300 are composed of the stocks of 225 and 300, respectively, actively-traded stocks on the Tokyo Stock Exchange (the "**TSE**"). All Equity and Index Options traded on the OSE are European-style in that they are exercisable only on their expiration date.

All OSE options are bought and sold in Japanese yen. OSE options are not fungible or interchangeable with options that are traded on any other market. Thus, any OSE option position opened can be closed only on the OSE or exercised through the OSE.

Membership in the OSE is limited to domestic securities companies or the Japanese branches of foreign securities companies licensed by the MOF or, after December 1, 1998, registered with the FSA. The companies that are authorized to trade Equity and Index Options on the OSE are the OSE's Regular Members and the Special Participants in Equity Options and Special Participants in Index Futures and Options (collectively, the "**Regular Members and Special Participants**").<sup>5</sup>

OSE option trading is conducted through the "Computer-Assisted Trading System". Regular Members and Special Participants enter orders into their computer terminals on the Computer-Assisted Trading System. Orders are registered into the central processing equipment where orders are computed and classified according to each issue and an order sheet is prepared. The orders are matched and executed automatically through the Computer-Assisted Trading System.

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<sup>5</sup> A Regular Member is a securities company principally engaged in all trading activities on the cash, futures and options markets of the OSE. A Special Participant is a non-member domestic securities company or a Japanese branch of a foreign securities company licensed by the MOF or, after December 1, 1998, registered with the FSA who is granted special permission by the OSE to participate in only the futures and options market of the Exchange. The Special Participant in Equity Options is qualified to trade only equity options on the OSE and the Special Participant in Stock Index Futures and Options is qualified to trade only stock index futures and options on the OSE.

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After a trade is executed, a contract execution notice is printed immediately at the printer of the Regular Members or Special Participants involved in the trade, and simultaneously, the contract information is announced automatically through electronic market information systems. All trading activity is monitored and observed by officials of the OSE through the use of control terminal equipment.

The OSE Clearing Administration Department (the "Clearing Department"), which is a department within the Exchange, clears and settles all transactions executed on the OSE. The Clearing Department does not become a counterparty to each contract on registration. Responsibilities on contracts remain with the Regular Member or Special Participant that executed the transaction. In general, the Clearing Department is responsible for providing the framework of rules and systems, administering the collection and payment of premiums and margins, and organizing and maintaining guarantee funds for contract performance and client compensation.

The settlement of an exercised Equity Option is made by delivery of the underlying stock at the exercise price. Under the Central Securities Depository System, transactions in shares are settled by book-entry (with the stock certificates held in custody by the Japan Securities Depository Center). Settlements of stock and cash are made through procedures whereby the Exchange receives the stock and/or cash on behalf of the relevant Regular Member or Special Participant. Settlement must be made on the fourth business day following the day of exercise (T+4).

The settlement of Index Options is by payment of the cash difference between the exercise price and the option settlement index between the purchasing Regular Member or Special Participant who exercised the option and the Regular Member or Special Participant who is assigned the exercise notice. As of November 30, 1998 (exercise date), settlement must be made on the next business day following the exercise date (T+1), except that a Regular Member or Special Participant may allow a non-resident customer to delay settlement until the second business day following the exercise date (T+2).

Each Regular Member and Special Participant is required to deposit and maintain margin with the OSE in respect of each option for which it represents the writer. Margin must be deposited by the selling customer with the Regular Member or Special Participant, and by the selling Regular Member or selling Special Participant with the Exchange.

Each selling customer and each selling Regular Member or Special Participant is required to maintain its deposited margin up to at least the amount (or more) calculated according to the margin calculation formulae on a net position basis. As of December 1, 1998, when a shortfall occurs, the customers must deposit the additional margin with the Regular Member or Special Participant on the next business day following the day the shortage arose (T+1) by the specific hour designated by the Regular Member or Special Participant. However, a Regular Member or Special Participant may allow a non-resident customer to delay its margin deposit until the second business day following the day on which the shortage arose (T+2). The Regular Member or Special Participant must deposit with the Exchange margin equivalent in value to the shortage in its own account or a customer's account by 12:00 p.m. on the next business day (by 11:00 a.m. on a half trading day) following the day on which the shortage arose (T+1).

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Regular Members and Special Participants are required to maintain monies and securities deposited as customers' margin separately from their own monies and securities. If a customer defaults on its obligations on an options contract, the Regular Member or Special Participant through whom it has acted may settle any unsettled position by conducting an offsetting transaction, exercising the option, or buying/selling the underlying stock, as appropriate, for the customer's account. If the Regular Member or Special Participant suffers a loss, it may appropriate the customer's monies and securities held by the Regular Member or Special Participant as compensation. If a Regular Member or Special Participant is or is expected to be in default, the OSE may suspend the Regular Member's or Special Participant's membership or qualification for trading and its receipt of any monies or securities through the Exchange and can appropriate such assets for the settlement of open positions.

In addition to each Regular Member's Subscription which contributes to the equity of the Exchange, and the OSE's rights to appropriate a defaulting Regular Member's or Special Participant's rights to monies or securities held in or transferred through the Exchange, there are a number of reserves and funds established to meet losses arising from a Regular Member's or Special Participant's default. The OSE establishes and maintains a Membership Guarantee Deposit ("**MGD**") from Regular Members and Special Participants to ensure settlement of customers' transactions. The Japanese Securities and Exchange Law provides that in the event that a Regular Member or Special Participant defaults on its obligations to a customer who orders and executes trades through such Member or Special Participant, the customer has the right to receive payment for its losses in preference to any Regular Member or Special Participant from the Regular Member's or Special Participant's MGD. Furthermore, if a defaulting Regular Member or Special Participant damages other Regular Members or Special Participants, the non-defaulting Regular Members or Special Participants also have the right to receive payment for damages from the defaulter's MGD, after the defaulter's customers are satisfied.

To meet any further losses, pursuant to its Constitution, the OSE maintains the Default Compensation Fund for Equity Options Trading (the "**Equity Options Fund**") and the Default Compensation Reserve for Futures and Options Trading (the "**Futures and Options Reserve**"). Regular Members and Special Participants are required to make special deposits with the OSE in cash or securities acceptable to OSE ("**Special Deposits**") for the Equity Options Fund and/or to make payments to the Futures and Options Reserve if they trade in Equity Options and/or Index Options, respectively.

If losses arise due to a default by a Regular Member or Special Participant on an Equity Options contract, the OSE appropriates the Special Deposit of the defaulting Regular Member or Special Participant to cover the resulting losses suffered by non-defaulting Regular Members and Special Participants. If there is a loss beyond the Special Deposit of the defaulter, the OSE can appropriate the Special Deposit of non-defaulting Regular Members or Special Participants to cover the losses.

In the event that there are losses after the appropriation of the Special Deposits, the OSE, after a resolution passed by 2/3 vote of the members present at a meeting of the Board of Governors of the OSE, can collect an extraordinary special dues from non-defaulting Regular Members and

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Special Participants. The special dues would be credited to the Equity Options Fund and used to cover the remaining losses.

A similar but not identical procedure is followed in respect of Index Options. If a Regular Member or Special Participant defaults on transactions in Index Options, the amounts held in the Futures and Options Reserve can be used to cover any losses to non-defaulting Regular Members or Special Participants. As in the case of Equity Options, any further losses can be covered, if approved by a resolution passed by 2/3 vote of the members present at a meeting of the Board of Governors of the OSE, by a collection of additional "Special Dues for Futures and Options Trading".

The OSE wishes to familiarize certain registered broker-dealers and large financial institutions in the United States with Equity and Index Options traded on the OSE. To do this, the OSE proposes to take the limited steps described below with respect only to "Qualified Broker-Dealers" and "Qualified Institutions". Accordingly, to be Qualified, each such entity must meet the following standards:

- (a) it must be a "qualified institutional buyer" as defined in Rule 144A(a)(1) under the Securities Act of 1933 (the "Securities Act"), or an international organization excluded from the definition of "U.S. person" in Rule 902(k)(2)(vi) of Regulation S under the Securities Act; and
- (b) it must have had prior actual experience with traded options in the U.S. options markets, and, therefore, have received the options disclosure document for U.S. standardized options required by Rule 9b-1 under the Exchange Act.

The OSE's Regular Members and Special Participants will be required to take reasonable steps to assure themselves, before effecting any OSE Equity or Index Option transactions for or with a customer located in the United States, that the customer is a Qualified Broker-Dealer or a Qualified Institution, that the customer is acting for its own account or the account of another Qualified Broker-Dealer or Qualified Institution or the managed account of a non-U.S. person (within the meaning of Rule 902(k)(2)(i) of Regulation S under the Securities Act), and that the customer has received the OSE option disclosure document referred to below. The OSE will advise OSE Regular Members and Special Participants that it has been advised that, under U.S. law, OSE Regular Members and Special Participants which are not U.S. registered broker-dealers may deal with Qualified Institutions only in accordance with Rule 15a-6 under the Exchange Act, principally through U.S. registered broker-dealers as provided in such Rule.

The OSE will institute rules requiring its Regular Members and Special Participants to furnish each Qualified Broker-Dealer and Qualified Institution with an OSE option disclosure document before accepting an order from that Qualified Broker-Dealer or Qualified Institution to purchase or sell an OSE option contract. These OSE rules also will require each OSE Regular Member and Special

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Participant to obtain from each Qualified Broker-Dealer or Qualified Institution the following written representations, signed by an appropriate officer of the Qualified Broker-Dealer or Qualified Institution:

- (1) that it is a Qualified Broker-Dealer or Qualified Institution, and that as such (a) it owns and invests on a discretionary basis a specified amount of eligible securities sufficient for it to be deemed a qualified institutional buyer under Rule 144A under the Securities Act and, if it is a bank, savings and loan association, or other thrift institution, that it has a net worth meeting the requirements of Rule 144A under the Securities Act, and (b) it has had prior actual experience in the U.S. traded options markets, and as a result thereof has received the options disclosure document entitled "Understanding the Risks and Uses of Listed Options" ("**Options Disclosure Document**" or "**ODD**") that is prepared by the Options Clearing Corporation and U.S. options exchanges;
- (2) that it has received the OSE option disclosure document;
- (3) that its transactions in OSE Equity and Index Options will be for its own account or for the account of another Qualified Broker-Dealer or another Qualified Institution, or for the managed account of a non-U.S. person within the meaning of Rule 902(k)(2)(i) of Regulation S under the Securities Act;
- (4) that it will not transfer any interest or participation in a OSE Equity or Index Option contract that it has purchased or written to any other U.S. person, or to any person in the United States, that is not a Qualified Broker-Dealer or Qualified Institution;
- (5) that (a) it will cause any disposition of an OSE option that it has purchased or written to be effected only on the OSE and to be settled on the OSE in Osaka; (b) it understands that any required payments for premiums, settlement, exercise, or closing of any OSE option contract in respect of which it has a contract with the OSE Regular Member or Special Participant must be made in Osaka and in Japanese yen; and (c) it understands that, if it is a writer of OSE option contracts, margin must be provided to the OSE Regular Member or Special Participant and maintained, measured and deposited in Japanese yen or any other instrument approved by the OSE;
- (6) that, if it is a Qualified Broker-Dealer or Qualified Institution acting on behalf of another Qualified Broker-Dealer or Qualified Institution that is not a managed account, it has obtained from the other Qualified Broker-Dealer or Qualified Institution written representations to the same effect as these representations, and that it will provide those written representations to the OSE Regular Member or Special Participant on demand; and

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- (7) that it will notify the OSE Regular Member or Special Participant of any change in the foregoing representations prior to placing any future order, and that the foregoing representations will be deemed to be made with respect to each order that it gives to the OSE Regular Member or Special Participant.

An OSE option disclosure document, in the form submitted to and reviewed by the Division (Exhibit A hereto) and as amended from time to time as discussed further below, will be provided only to Qualified Broker-Dealers and Qualified Institutions. The document provides an overview of that part of the OSE which consists of an Equity and Index Options market, with attention to significant differences from standardized options in the U.S. domestic options market, and sets forth special factors relevant to U.S. entities transacting in OSE Equity and Index Options.

The OSE will appoint certain officers located in Osaka to act as the OSE's representatives in the United States (the "OSE Representatives"). The OSE Representatives will be available to respond to inquiries concerning the OSE from Qualified Broker-Dealers and Qualified Institutions. OSE Representatives may make personal calls on and correspond or otherwise communicate with entities whom the representatives reasonably believe to be Qualified Broker-Dealers and Qualified Institutions to familiarize them with the existence and the operations of the OSE. Any Qualified Broker-Dealer or Qualified Institution would be provided with the OSE option disclosure document upon its first visit, communication, or inquiry. The OSE Representatives located in Osaka will maintain a reasonable supply of that document, and of the most recently published annual financial report of the OSE, prepared in English, for distribution to Qualified Broker-Dealers and Qualified Institutions upon request. An OSE Representative may also participate in programs and seminars in the United States.

The OSE Representatives will not give investment advice or make any recommendations with respect to specific OSE Equity or Index Options, nor will the OSE Representatives solicit, take, or direct orders, nor recommend or refer Qualified Broker-Dealers or Qualified Institutions to particular OSE Regular Members or Special Participants. If requested by a Qualified Broker-Dealer or Qualified Institution, the OSE Representatives may make available to the requester a list of all OSE Regular Members or Special Participants permitted to take orders from the public and any registered U.S. broker-dealer affiliates of such OSE Regular Members or Special Participants. The OSE will not engage in any general advertisement concerning OSE Equity or Index Options in the United States.

The OSE will continue to be an organized exchange operating and regulated outside the U.S. and, while making its OSE Equity and Index Options known to a particular, sophisticated segment of the U.S. financial community, the Exchange will experience no substantial changes in the foregoing facts and circumstances. Careful limitations also will be taken to assure compliance with applicable U.S. securities laws, and the OSE will continue as necessary to establish further limitations to assure continued compliance with applicable U.S. securities laws.

Making information concerning the OSE available in the United States as described in this letter will serve to increase, in a responsible manner, information concerning an important and growing

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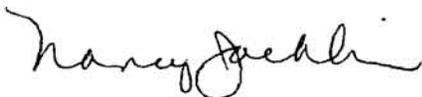
marketplace in Japan that will be of substantial benefit to appropriate U.S. professionals and institutions.

We therefore respectfully request on behalf of the OSE that you confirm to us that the Division will not recommend that the Commission take enforcement action of the nature set forth in the opening paragraph of this letter. In addition, we also request that the Division confirm (a) that furnishing the OSE option disclosure document by the OSE Representatives from outside the United States, by an OSE Regular Member or Special Participant or by a Qualified Broker-Dealer, in each case, to a Qualified Broker-Dealer or Qualified Institution will satisfy the obligation of a broker or dealer under Rule 9b-1(d) to furnish an options disclosure document before accepting an order from a customer to purchase or sell an OSE Equity or Index Option, and (b) that neither the furnishing of the OSE option disclosure document to a Qualified Broker-Dealer or Qualified Institution by the OSE Representatives from outside the United States nor an OSE Regular Member's or Special Participant's furnishing of the disclosure document to a Qualified Broker-Dealer or, in response to an unsolicited inquiry concerning Equity or Index Options, to a Qualified Institution, will constitute solicitation or the provision of a research report as those terms are used in Rule 15a-6(a). In each case the Qualified Broker-Dealer or Qualified Institution will have previously received the ODD. In addition, the OSE will require that OSE Regular Members or Special Participants, before effecting a transaction with or for a Qualified Broker-Dealer or Qualified Institution in Equity or Index Options traded on the OSE, determine as described above that the Qualified Broker-Dealer or Qualified Institution has received the ODD and the OSE option disclosure document and maintain a record of that determination.

The OSE will furnish the Division, at least 30 days prior to the date definitive copies are furnished to Qualified Broker-Dealers or Qualified Institutions, with a copy of any amendment made to the OSE option disclosure document because the information contained in that document becomes or will become materially inaccurate or incomplete, or because there is or will be an omission of material information to ensure that the document is not misleading.

If you need additional information concerning this request, please call me at (212) 709-4200.

Sincerely,



**Nancy Jacklin**