



COMMENT

June 18, 2001

Mr. Jonathan G. Katz
Secretary
Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549-0609

Commodity Futures Trading Commission
Attention: Office of the Secretariat
Three Lafayette Centre
1155 21st Street, N.W.
Washington, D.C. 20581

RE: File No. S7-11-01

Dear Mr. Katz and Ms. Webb:

The Chicago Board Options Exchange, Incorporated ("CBOE") is pleased to comment on File No. S7-11-01, "Method for Determining Market Capitalization and Dollar Value of Average Daily Trading Volume; Applications of the Definition of Narrow-Based Security Index." The Securities and Exchange Commission ("SEC") and the Commodity Futures Trading Commission ("CFTC") (collectively "Commissions") proposed rules regarding the definition of "narrow-based security index" pursuant to the Commodity Futures Modernization Act of 2000 ("CFMA").¹ Specifically, the CFMA directs the Commissions to jointly specify by rule or regulation the method to be used to determine "dollar value of average daily trading volume" and "market capitalization" for purposes of the new definition of "narrow-based security index" and the exclusion to this definition in the Commodity Exchange Act ("CEA")² and the Securities Exchange Act of 1934 ("Exchange Act").³

Introduction

¹ Pub.L.N. 106-554, 114 Stat. 2763 (2000).
² Section 3(a)(55)(F)(ii) of the Exchange Act, 15 U.S.C. 78(c)(55)(F)(ii).
³ Section 1a(25)(E)(ii) of the CEA, 17 U.S.C. 1a(25)(E)(ii).

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When the CFMA was enacted, on December 21, 2000, it permitted for the first time in the U.S., trading of futures on single stock and narrow-based security indexes (“security futures”). Prior to the enactment of the CFMA, the only futures on equities that were permitted were futures on broad-based security indexes and exempt securities. The CFMA amends the Exchange Act and the CEA to permit the trading of security futures. Thus, both the SEC and the CFTC have jurisdiction over security futures, but only the CFTC has jurisdiction over futures on broad-based security indexes. Because of the jurisdictional differences, among others, whether a futures contract is based on a broad-based security index or a narrow-based security index will have significant impact.

The CFMA defines the term “narrow-based security index” as a security index that meets one of the four following criteria: 1) is composed of nine or less securities; 2) has a component security which makes up more than 30 percent of the index’s weighting; 3) the five highest weighted component securities, in the aggregate, comprise more than 60 percent of the index’s weighting; or 4) the lowest 25 percent weighted securities, in the aggregate, have a dollar value of average daily trading volume of less than \$50 million (or in the case of an index with 15 or more securities \$30 million).⁴ However, even if an index falls within one of the four criteria, it may be excluded from the definition of “narrow-based security index” if one of several criteria apply.⁵

⁴ Section 3(a)(55)(B) of the Exchange Act, 78(c)(3)(a)(55)(B) and Section 1a(25)(A) of the CEA, 17 U.S.C. 1a(25)(A).

⁵ Section 3(a)(55)(C) of the Exchange Act and Section 1a(25)(B) of the CEA state:
Notwithstanding [the above paragraph], an index is not a narrow-based security index if ---
(i)(I) it has at least 9 component securities;
(II) no component security comprises more than 30 percent of the index’s weighting; and
(III) each component security is --
(aa) registered pursuant to section 12 of the Exchange Act;
(bb) 1 of 750 securities with the largest market capitalization; and
(cc) 1 of 675 securities with the largest dollar value of average daily trading volume;
(ii) a board of trade was designated as a contract market by the Commodity Futures Trading Commission with respect to a contract of sale for future delivery on the index, before the date of enactment of the Commodity Futures Modernization Act of 2000;
(iii)(I) a contract of sale for future delivery on the index traded on a designated contract market or registered derivatives transaction execution facility for at least 30 days as a contract of sale for future delivery on an index that was not a narrow-based security index; and
(II) has been a narrow-based security index for no more than 45 business days over 3 consecutive calendar months;
(iv) a contract of sale for future delivery on the index is traded on or subject to the rules of a foreign board of trade and meets such requirements as are jointly established by rule or regulation by the [SEC] and the [CFTC];
(v) no more than 18 months have passed since the date of enactment of the Commodity Futures Modernization Act and--
(I) it is traded on or subject to the rules of a foreign board of trade;
(II) the offer and sale in the United States of a contract of sale for future delivery on the index was authorized before the date of the enactment of the Commodity Futures Modernization Act; and
(III) the conditions of such authorization continue to be met; or
(vi) a contract of sale for future delivery on the index is traded on or subject to the rules of a board of trade and meets such requirements as are jointly established by rule, regulation, or order by the [SEC] and the [CFTC].

Regulatory Parity

Before commenting on the specifics of the Commissions' proposals, CBOE wants to comment on the disparity between the proposals and the regulatory treatment of stock index options. Currently, index options are classified pursuant to SRO rules as either narrow-based or broad-based. This classification has important consequences for position limits, margin, and tax purposes because options on broad-based indexes are subject to higher position limits, lower margin requirements, and wider application of favorable 60/40 tax treatment than options on narrow-based indexes. More importantly, broad-based index futures are not subject to the securities laws. Consequently, they have lower margin requirements and higher position limits than broad-based index options, and much lower margin and much higher position limits than narrow-based index options. They also receive favorable 60/40 tax treatment for all customers.

The securities SRO standards for determining whether an index underlying an option is broad-based is much more restrictive than the standards in the CFMA for security futures products, in large part because the CFMA standards emanate from an agreement between the Commissions last year during the legislative process leading to the CFMA. Prior to enactment of the CFMA, the SEC required the securities SROs to adhere to a more restrictive standard for index options. With the passage of the CFMA, CBOE believes that the definition of "narrow-based security index" in Section 3a(55)(B) of the Exchange Act should also be applied to options. CBOE intends to change its rules to adopt the CFMA standards for a narrow-based index for our index options classification.⁶ It is crucial that CBOE be able to do so before the introduction of security futures products. Otherwise, a future overlying a stock index could receive a large competitive advantage over an option on the same index merely because the terms "narrow-based security index" and "broad-based security index" would have different meanings for futures and options. If the dividing line between narrow-based security indexes and broad-based security indexes for options is different than the dividing line between narrow-based security indexes and broad-based security indexes for futures, then the regulatory inequity could drive an individual's decision in choosing options or futures. Economics and not regulation should drive an individual's decision. Therefore, the definition of narrow-based security index should be the same for options and security futures.

⁶ The tax treatment of broad-based versus narrow-based stock index options under Treasury regulations automatically uses the definition of narrow-based index contained in the Exchange Act.

Security Indexes Excluded from the Definition of Narrow-Based Security Index

The CFMA, by amending the Exchange Act and the CEA, mandates that the Commissions jointly specify the method to be used to determine market capitalization and dollar value of average daily trading volume.⁷ The Commissions are also required, by December 21, 2001, to jointly adopt rules or regulations that set forth the requirements that a foreign board of trade must meet in order for a futures contract on a security index to be excluded from the definition of a “narrow-based security index.”⁸

Index’s Component Securities Have High Market Capitalization and Dollar Value of Average Daily Trading Volume

A security index may be excluded from the definition of “narrow-based security index,” and thus security futures, if (i)(I) it has at least 9 component securities; (II) no component security comprises more than 30 percent of the index’s weighting; and (III) each component security is: (aa) registered pursuant to section 12 of the Exchange Act; (bb) one of 750 securities with the largest market capitalization (“Top 750”); and (cc) one of 675 securities with the largest dollar value of average daily trading volume (“Top 675”). The Commissions have asked whether they should determine the Top 750 and the Top 675.

CBOE believes that given the consequences whether a security index is considered narrow-based or broad-based, it is important to have one official source that determines the Top 750 and Top 675 securities in each of the designated categories. It would lead to inconsistent results to have one self-regulatory organization (“SRO”) compute the Top 750 and Top 675 in a way to make a security index broad-based, while another SRO using the same securities index with the same component security considers it narrow-based.

The official source could be the SEC, the CFTC, a designee of the Commissions or a third party source.⁹ Having one official source to list the Top 750 and the Top 675 would remove the errors in the computing of the numbers, and thus reduce ambiguity. In this way, all SROs participating in this market would be assured that all markets trading security futures would abide by the same standard. It would also limit disputes over which stocks comprise the Top 750 and the Top 675. An official source would also

⁷ Section 3(a)(55)(F)(ii) of the Exchange Act, 15 U.S.C. 78(c)(55)(F)(ii), and Section 1a(25)(E) of the CEA, 17 U.S.C. 1a(25)(E).

⁸ Section 3(a)(55)(D) of the Exchange Act, 15 U.S.C. 78(c)(55)(D), and Section 1a(25)(C) of the CEA, 17 U.S.C. 1a(25)(C).

⁹ The official third party source could be chosen by the Commissions or by the SROs that would use the information compiled by the third party. Whether the designee of the Commissions or a third party provide the required information, the reasonable costs for this service could be assessed on pro rata basis among those SROs using the service. This sharing of reasonable costs would reduce the overall expense of computing this information, and thus is an efficient way to reduce the expense for all SROs required to make these computations.

provide better customer protection, because there would be consistent treatment of security indexes as broad-based or narrow-based.

Proposed Rule for Futures Contracts Traded on or Subject to the Rules of a Foreign Board of Trade

Under the proposed rules of the Commissions, when a futures contract on an index is traded on or subject to the rules of a foreign board of trade, such index would not be a narrow-based security index (i.e., it would be broad-based), if it would not be considered a narrowed-based security index on a designated contract market or registered DTEF. The Commissions request comment on whether it would be appropriate for the statutory definition of "narrow-based security index" and the exclusion from that definition to be the sole criteria for security index that are traded on foreign boards of trade. The Commissions also request comment on whether the depth of the market, the concentration of the component securities, the permissibility of any affiliation among the issuers of component securities, the liquidity of component securities, among other factors, should be considered.

Securities indexes traded on a foreign-board of trade should be held to the same standards as those for security indexes traded on U.S. SROs. This should not only be true for the security indexes and component securities, but it should also be true of the foreign boards of trades. The foreign boards of trade should be subject to equivalent customer protection and regulatory requirements as U.S. SROs.

The Commissions should not look at the trading of security indexes or their component security trading on foreign boards of trade in a vacuum. Susceptibility to manipulation should continue to guide the Commissions in determining the status of a security index traded on a foreign board of trade. Any processes developed by the Commissions should recognize the divergence from country to country in market depth, liquidity of the futures on the security index, as well as the component stock of the index, and concentration of the component securities, as well as other factors that are important when surveilling for manipulation. While some countries may in fact have securities with higher market value that are traded more actively than stocks listed in U.S. markets, other countries may have less developed markets that lack the liquidity and depth to be equivalent to the statutory and proposed standards of the Commissions. Due to this divergence it is important that the Commissions consider the susceptibility to manipulation in these markets.

The determination of whether a security index underlying futures traded on a foreign board of trade is narrow-based or broad-based, requires considerable information. Information about foreign securities is frequently scarce, and even in those countries where this information is available, there can be multiple sources for this information. For example, in order to compute the average daily trading volume one needs to know the

total number of shares outstanding, but this information can be difficult to obtain in a timely fashion. Not all foreign regulators have company reporting requirements similar to the U.S. securities laws. So, where an SRO may be able to use Form 10K or Form 10Q to discover a company's total outstanding shares, other countries may not require similar disclosure of company information. In order to have access to the type of information necessary to make the computations required under the proposed rules, there should be one official source of information similar to that proposed earlier. This will assure consistency in the computation of whether a securities index is narrow-based or broad-based, and will in addition provide customers with valuable information.

Since the liquidity and market value of stocks in various foreign countries can differ, the component securities of an index trading on a foreign board of trade should be subject to the same liquidity and market values as those that apply in the U.S. Thus, the component securities should have the same capitalization as the Top 750 U.S. securities and the same dollar value of average daily trading volume as the Top 675 U.S. securities.

The four criteria used to define a narrow-based security index for U.S. component securities should also apply to foreign component securities. The liquidity criteria ensures that market participants would be able enter and exit positions as easily in foreign countries as they can in the U.S.

Security indexes with non-U.S. component securities should only be excluded from the definition of narrow-based security index, if all of the component securities are at least as large as the security of the company that is ranked 750th for market capitalization and 675th for dollar value of average daily trading volume in the U.S. This would ensure that that index is composed of stocks with the liquidity and size deemed adequate by the CFMA. This would also mean that the number of component non-U.S. securities could be greater than or less than the 750 or 675 for each category. For example, in the event that a country's stock market grows in size relative to the U.S., and it had a robust, well developed securities market with liquid markets, it might be possible for 1,000 or more securities to be component securities. On the other hand, for example, if a foreign country had a less developed securities market with little liquidity, it might only have 40 securities that would be eligible to be component securities under the recommended standard (calculation). This comparison of non-U.S. securities to the securities of the company that is ranked 750th for market capitalization and 675th for dollar value of average daily trading volume in the U.S. could be done in the same manner as recommended for U.S. securities on a quarterly basis.

A Futures Contract on a Broad-Based Security Index that Becomes Narrow-Based

The Commissions request comment on whether they should specify expressly the extent of changes a designated contract market, derivatives transaction execution facility, or foreign board of trade needs to make to an index before the end of the temporary three month grace period so that it does not need to comply with the applicable securities laws. The CBOE believes the Commissions generally should not specify any changes to a

particular index. However, the Commissions may want to provide exceptions in cases where the selection of component securities of the index is outside the SRO's control.

Method for Determining Market Capitalization and Dollar Value of Average Daily Trading Volume

The CFMA directs the SEC and CFTC to "...jointly specify the method to be used to determine market capitalization and dollar value of average daily trading volume."¹⁰ For the purpose of the statute, market capitalization and dollar value of average daily trading volume "...shall be calculated as of the preceding six full calendar months."¹¹ Under the proposed rules, market capitalization is defined as the number of outstanding shares of a security as reported by a company's annual or quarterly report multiplied by the "average price" of a security over the preceding six full calendar months. Dollar value of average daily trading volume is defined as the product of a security's average daily trading volume and its "average price" over the preceding six full calendar months.

Determining Market Capitalization

There should be no ambiguity in the determination of market capitalization and dollar value of average trading volume. The method should be replicable and should yield the same results for all parties. However, the proposed rules – and even the simplified approaches recommended in these comments – leave room for ambiguity due to possible differences in source data. For the reasons stated previously, and to remove all ambiguity, CBOE believes the Commissions should publish an official list of securities that rank the Top 750 by market capitalization and Top 675 by dollar value of average daily trading volume. This list would need to be published daily so that SROs and others could check compliance with the definition of "narrow-based" security index at the appropriate times and perform a day count for security indexes that may be in the midst of a "grace period."

"Average Price" Determination

In order to determine market capitalization and dollar value of ADTV, the commissions propose a "volume-weighted average price" method, which uses volume and price information for each transaction during a six-month period. Theoretically, this method would, indeed, provide an accurate measure of "average price." However, a tremendous amount of data would be needed to implement this proposed method. The most active securities are typically the subject of several thousand transactions daily. At any given time, an SRO or its designee would need six months of data on millions of individual transactions, thereby creating an enormous burden on resources. CBOE estimates that it would need at least two additional staff in order to adequately monitor

¹⁰ Section 3(a)(55)(F)(ii) of the Exchange Act, 15 U.S.C. 78(c)(55)(F)(ii) and Section 1a(25)(E)(ii) of the CEA, 17 U.S.C. 1a(25)(E)(ii).

¹¹ 66 FR 27559 (May 17, 2001).

the “average price” for all securities registered under Section 12 of the Exchange Act under the proposed rules.

Given the number of transactions involved and the possible ambiguity of prices and trades to be included, it is extremely unlikely that the “average price” calculated by one SRO would match the “average price” calculated by other SROs. Since this “average price” is used to determine the Top 750 and Top 675, it is possible that different SROs could generate different lists.

CBOE believes the simpler approach would be to determine “average price” based on the average of closing prices observed in the primary market during regular trading hours. If a security is traded on a listed market, such as NYSE or AMEX, the closing price should be the price reported by the SRO. If a security is traded on NASDAQ-NMS, the closing price should be considered the last sale reported during regular trading hours.

Average Daily Trading Volume

The Commissions propose that the ADTV of a security be defined as the total number of shares of such security traded on the trading days of the principal market for the security during the preceding six full calendar months divided by the number of trading days on the principal market for the security during the same period. The proposed method of adding the daily volume over the preceding six months and dividing by the number of days in that period is reasonable. However, the Commissions must clearly define the volume that is to be included. For example, should trading activity during extended trading hours be included?

CBOE proposes that volume executed in the principal market during regular trading hours should be included in the determination of ADTV. For foreign securities, however, the principal market would be defined as the principal listing exchange in the U.S. For example, Nortel is a Canadian company, listed in both U.S. and Canada. CBOE proposes to include only the volume traded on the NYSE (principal U.S. market) in the ADTV calculation, even though an argument could be made that the principal market is in Canada. Using shares reported in annual or quarterly reports is a reasonable approach. It will be necessary, however, to monitor for share changes resulting from splits, mergers, and other corporate actions that occur between reports. CBOE agrees with the Commissions that a rolling six-month period is appropriate.

The Commissions also request comment on whether, when determining the ADTV of a non-U.S. security, the ADTV of the American Depositary Receipt (“ADR”) representing shares of such security should be included. CBOE believes that an ADR should be considered registered pursuant to Section 12 of the Exchange Act for computation purposes, because they represent volume of the underlying non-U.S. securities. The Commissions also requested comments on whether the ADRs should be computed on a proportional basis of the underlying shares when determining the average price of a security. CBOE also believes the ADR should be computed on a pro rata basis

with the underlying non-U.S. securities. For example, if the ADR represents 20 shares of a non-U.S. security, then for computation purposes the number 20 should be used in the computation.

CBOE also requests that the Commissions consider an ADR registered under Section 12 of the Exchange Act, for listing standard purposes. The listing standards for security futures require that any security underlying a security futures be registered pursuant to Section 12 of the Exchange Act. As the Commissions stated in their proposing release, the security of an issuer that underlies an ADR is registered under Section 12 of the Exchange Act and the ADR is a separate security that is exempt from registration. Because the underlying security is registered under Section 12 of the Exchange Act, for purposes of security futures, the ADR should be considered the equivalent or the same as a security registered under Section 12 of the Exchange Act.

The Lowest Weighted 25 Percent of an Security index

The proposed rules would establish that the “lowest weighted 25 percent of an index’s weighting” is comprised of those component securities that have the lowest weightings in the index such that, when their weightings are summed, they equal no more than 25 percent of the weight of the index. The same methodology should apply for determining the dollar value of average daily trading volume for the lowest weighted securities comprising, in aggregate, 25% of an index’s weight as proposed for evaluating the Top 750. The Commissions, in addition to publishing a list for the Top 750 and the Top 675, should extend the list for all Section 12 securities. If an index component is not a Section 12 security, and therefore, not included on the published list, it will be the responsibility of the SRO on which the index is listed to determine ADTV and monitor it on an on-going basis.

Conclusion

CBOE appreciates the complexity of the task that lay before the Commissions, as well as the time constraints. CBOE, also, believes that the ultimate accuracy of the methods used to rank stocks is less important than making sure everyone refers to the same group of stock so that there are no disputes over what is a narrow-based security index and what is not. CBOE believes that a level playing field must be maintained across products, across regulators and across national boundary lines.

If you have any questions regarding our comments, or would like to discuss our comments further, please feel free to contact Joanne Moffic-Silver at (312) 786-7462.

Sincerely,
Joanne Moffic-Silver
General Counsel

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