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COMMENT

June 25, 2001

BY CERTIFIED MAIL AND E-MAIL

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Commodity Futures Trading Commission
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1155 21st Street, N.W.
Washington, D.C. 20581

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

Re: Narrow-Based Security Indexes —66 Fed. Reg. 27559 (May 17, 2001)
SEC File No. S7-11-01

Dear Ms. Webb and Mr. Katz:

The Board of Trade of the City of Chicago, Inc. ("CBOT®") appreciates the opportunity to comment on the jointly proposed rules of the Commodity Futures Trading Commission ("CFTC") and the Securities and Exchange Commission ("SEC") (collectively, "Commissions") with regard to the proposed Method for Determining Market Capitalization and Dollar Value of Average Daily Trading Volume and the Application of the Definition of Narrow-Based Security Index.

I. Introduction

New Part 41 regulations have been proposed under the Commodity Exchange Act ("CEA"), and Rules 3a55-l through 3a55-3 have been proposed under the Securities Exchange Act of 1934 ("Exchange Act"), to implement statutory provisions contained in the Commodity Futures Modernization Act of 2000 ("CFMA") that, in part, lifted the ban on narrow-based security index futures, and provided for the Commissions to jointly regulate these products.

Before the CFMA was enacted, the Shad-Johnson Accord ("Accord"), embodied in former Section 2(a)(1)(B) of the CEA, governed trading in futures on security indexes. Under that Accord, futures exchanges were permitted to offer futures contracts on security indexes if the contracts satisfied the following statutory criteria: (1) the contract had to be cash-settled; (2) the contract could not be readily susceptible to manipulation; and (3) the underlying securities had to measure and reflect the entire market or a substantial segment of the market. Futures contracts based upon narrow-based indexes or on individual securities were prohibited.

Prior to the enactment of the CFMA, both the CFTC and the SEC reviewed futures contracts based on security indexes to ensure compliance with the Accord. The issue of the definition of an index that could then permissibly form the basis for a futures contract was litigated in Board

of Trade of the City of Chicago v. SEC, 187 F.3d 713 (7th Cir. 1999). In that case, the court concluded that the Dow Jones Utilities and Transportation Averages met the criteria of the Accord, even though the stocks in the indexes may not themselves have constituted a substantial segment of the market, because they reflected the market performance of the industries they were designed to measure, which industries were a substantial segment of the market. The House Commerce Committee indicated that it did not intend any provision of Title II of the CFMA, including the definition of a narrow-based security index, to disturb the determination of the Seventh Circuit in the Board of Trade case. House Commerce Committee Report No. 106-711, Part 3, pgs. 60-61.

The Board of Trade fully appreciates the exceptional efforts by the Commissions' staff to implement quickly and in a "market-friendly" manner the dividing lines for narrow-based security indexes and broad-based security indexes contained in the CFMA's provisions. We believe that in answering each of the questions posed by the Commissions and ultimately in adopting any rules in this area, it is important to consider the reasons for these statutory dividing lines.

Congress wanted the decision whether a security index was broad or narrow to be able to be made under a bright line test that would be straightforward and easy to use. Simplicity should therefore be the predominant guideline. At the same time, Congress did not want to allow new security futures products – whether futures on single stocks or futures on narrow-based indexes – that could be used for insider trading that could compromise the integrity of the securities markets. In developing the rules governing the statutory numerical dividing lines, the Commissions should make every effort to treat as narrow-based indexes only those indexes that could pose a realistic and credible threat of insider trading in a company's stock if that index becomes the subject of a futures contract. Even if an index does not technically meet each of the numerical tests, that index should still be eligible to be a broad-based index if the threat of insider trading is not realistically presented. And finally Congress sought to avoid regulatory arbitrage. Congress understood that CEA-excluded markets – both electronic and physical trading markets -- would and could offer products identical to security futures products and would not be subject to the new regulatory regime for security futures. Unduly complicated, costly or restrictive numerical dividing lines would have the unintended consequence of creating legal uncertainty as well as heightened regulatory arbitrage. Those considerations could push the development of these new products into the CEA-excluded markets where neither the traditional futures regulatory apparatus nor the new hybrid security futures regulatory structures would be applicable. The Commissions should make every effort to avoid that outcome.1 The CBOT urges the Commissions to be guided by these public policy objectives in adopting final rules in this area.

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[1] In many respects, the unanimous President's Working Group Report on *Over-the-Counter Derivatives Markets and the Commodity Exchange Act* provided the public policy contours for what Congress ultimately enacted. That report underscored the need to repeal the ban on security futures products in a way that avoided regulatory arbitrage and would not pose a threat to the integrity of the securities markets.

As stated above, the CFMA attempted to set forth a bright line test for determining whether a security index is narrow-based, and thus subject to the joint jurisdiction of the SEC and the CFTC, or broad-based, and subject to the exclusive jurisdiction of the CFTC. Specifically, Section la(25)(A) of the CEA and Section 3(a)(55)(B) of the Exchange Act provide that an index is narrow-based if it has any of the following characteristics: (i) it has nine or fewer component securities; (ii) a component security comprises more than 30% of the index's weighting; (iii) the five highest weighted component securities in the aggregate comprise more than 60% of the index's weighting; or (iv) 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 ("$ADTV") of less than $50,000,000 (or in the case of an index with 15 or more component securities, $30,000,000).

Section la(25)(B) of the CEA, and Section 3(a)(55)(C) of the Exchange Act, provide that, nevertheless, an index is not narrow-based if all of the following criteria are met: (i) it has at least nine component securities; (ii) no component security comprises more than 30% of the index's weighting; (iii) each component security is registered pursuant to Section 12 of the Exchange Act; and (iv) each component security is one of 750 securities with the largest market capitalization ("Top 750"), and one of 675 securities with the largest $ADTV ("Top 675"). If an index has all of these characteristics, it is excluded from the definition of a narrow-based security index, and it is, therefore, broad-based.

The proposed rules have been issued in accordance with the mandate of the CFMA that the Commissions specify the methods to be used to determine the $ADTV and market capitalization for purposes of the definition of a narrow-based security index and the exclusions from that definition. In addition, the proposed rules govern certain circumstances when broad-based security indexes become narrow-based, or when narrow-based security indexes become broad-based.

In general, the CBOT notes that the statutory definitions, as the Commissions propose to apply them, will create a heavy administrative burden for exchanges that offer futures contracts based upon either broad-based or narrow-based indices. Exchanges would be required to perform (or obtain) lengthy calculations to determine the narrow-based or broad-based status of an index, on a daily basis, for as long as such a product continues trading, and to preserve voluminous records documenting these daily calculations. For a market that plans to launch a futures contract based on a broad-based index, it would be necessary to perform these calculations for at least six months prior to launch, to ensure that the index would continue to be treated as broad-based for a reasonable period of time if it were to become narrow-based within the first 30 days of trading.

It should be noted that under the Accord, daily calculations to ensure that an index remained broad-based, were not required. The Commissions had issued an Interpretation and Statement of General Policy that set forth what they believed to be the minimum criteria defining what was then a permissible index forming the basis of a futures contract (when the index was composed only of securities of issuers in the same or a similar industry). <u>Designation Criteria for Futures Contracts and Options on Futures Contracts Involving Non-Diversified Stock Indexes of</u>

Domestic Issuers. [1982-1984 Transfer Binder] Comm. Fut. Law Rep. (CCH) ¶21,970 (January 24, 1984). These criteria were very specific in terms of the number of securities in the index, index capitalization, and index concentration. Although the Statement of General Policy did not carry the force of law, it set forth the criteria that markets proposing new contracts were expected to address as of the date of the submission of their applications for designation to trade the types of stock index futures to which it applied.

However, neither the Accord nor the Statement of General Policy explicitly required an exchange to perform daily calculations to ensure that a listed futures contract remained within the definition of a permissible stock index futures contract on each and every trading day. Rather, the Commissions simply stated that an application by a board of trade must include rule proposals providing that the relevant index would be brought back into compliance with the terms of the guidelines, if at any time, it failed to meet any of the guidelines, with the exception of the capitalization standard. With regard to the capitalization standard, the guidelines provided that if, after trading commenced, the index capitalization were to fall below two-thirds of the requisite amount, no new trading months could be listed under the index until the two-thirds level was restored.

Under the statutory framework, the determination of whether an index is narrow-based or broad-based requires calculations of $ADTV and market capitalization as of the preceding 6 full calendar months, and the application of the statutory grace period is dependent upon a determination of whether a broad-based security index has been a narrow-based security index for more or less than 45 business days over 3 consecutive calendar months. Therefore, the clear implication is that these cumbersome and resource-intensive daily calculations must be made in order to ensure that a broad-based index remains broad-based. The CBOT continues to believe that it would be a much more workable approach to define an index as narrow-based or broad-based as of the date of the submission of the index futures contract for approval, or as of the date of its certification, as applicable, and as of the date of contract launch, and to require that it remain within those definitions at the end of certain periods, whether they be monthly, quarterly, or semi-annually, in order to continue to be treated as narrow-based or broad-based.

The Commissions have requested comments on the rules that it has proposed to adopt, given the restrictions of the statutory framework, and have posed 36 specific questions relating to the definition of a narrow-based security index and the method for determining market capitalization and $ADTV. The CBOT has addressed a number of the issues raised by the proposal, in the context of some of the Commissions' specific questions, below.[2]

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[2] Although beyond the scope of the Commissions' request for comments, the American Stock Exchange ("AMEX"), in its comment letter, requested that the Commissions confirm that shares of Exchange Traded Funds ("ETFs") would be classified as single securities, such that futures on shares of ETFs would fall within the definition of security futures. The CBOT does not believe that all shares of ETFs should be so classified. A basic reason underlying the creation of the hybrid security futures category was to prevent insider trading abuses in connection with single stock futures. It is inconceivable that a reasonable insider would use a futures contract on shares of an ETF as a basis for insider trading in connection with one of the stocks in the fund. In this area, the Commissions should apply substance over form. If the underlying basket of securities for an ETF is broad-based, then futures on

II. Definition of Narrow-Based Security Index

A. Top 750 and Top 675

Q1 and Q2 One of the statutory characteristics that an index must have in order to be excluded from the definition of a narrow-based security index is that each component security must be one of the Top 750 and the Top 675, as defined above. The Commissions have requested comment with regard to whether it would be difficult for market participants to determine the Top 750 and Top 675, and whether the Commissions should undertake to determine the Top 750 and Top 675.

Regardless of whether the Top 750 and the Top 675 are determined based upon all Section 12 – registered securities, or a subset of those securities, e.g., the stocks in the Russell 3000, or the Russell 2000, or the combined stocks of the New York Stock Exchange, the Nasdaq National Market System, and the American Stock Exchange, it would be very cumbersome for market participants to continually download the daily data necessary to make these determinations. The CBOT, therefore, believes that the Commissions should publish lists of the Top 750 and the Top 675 that could be referenced by all exchanges offering, or considering offering, futures on security indexes. The CBOT suggests that these lists be revised no more frequently than on a semi-annual basis, in order to minimize the disruption that would occur if a broad-based index were to become narrow-based, as a result of a component security being removed from one or the other of the lists.

B. Statutory Grace Period

Section 3a(55) of the Exchange Act and Section 1a(25) of the CEA provide that if futures on an index have traded for at least 30 days as futures on a broad-based index, and the index becomes narrow-based for no more than 45 business days over 3 consecutive calendar months, it will continue to be treated as a broad-based index. However, if the index has been broad-based for the initial 30 days, but has become narrow-based for more than 45 business days over 3 consecutive calendar months, it will be treated as narrow-based after an additional 3 calendar month grace period. Proposed CFTC Regulation 41.12(b) and (c) and proposed SEC Regulation 3a55-2(b) and (c) implement these statutory provisions for indexes that cease being broad-based. The CFTC has proposed to adopt Regulation 41.14, to address the converse situation where a narrow-based index becomes broad-based, in a similar manner.

Proposed Regulation 41.14(c) addresses trading in months with open interest, when a narrow-based index has become broad-based, and the transition period has expired, in order "to minimize disruption." Specifically, it permits a national securities exchange to continue to trade only in those months in the security futures product that had open interest on the date the transition period ended, and requires that it limit trading to liquidating positions. No parallel regulations have been proposed to address open interest when a broad-based index becomes

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the shares of that ETF should not be treated as security futures. On the other hand, if the underlying basket of securities for an ETF is narrow-based, then futures on shares of that ETF should be traded only as security futures.

narrow-based. It is equally necessary, in order "to minimize disruption", to explicitly allow, at a minimum, liquidating trades in months with open interest when a broad-based index has become narrow-based.

Q4 The Commissions have requested whether they should specify the extent of changes a market would need to make to an index, during the statutory grace period, if it was broad-based, but has become narrow-based, in order to avoid the application of the laws applicable to security futures products. The CBOT believes that the Commissions should not mandate any specific changes that must be made to index composition in order to permit such an index to continue trading as broad-based. In many cases, indexes are licensed from third parties, and the index providers might not agree and/or be able to change the composition of an index according to specific requirements imposed by the Commissions. Any changes should be permitted to be subject to careful analysis and, if necessary, negotiation between an exchange and an index provider, with due regard for the effect any such changes would have on market participants who hold open positions. Therefore, exchanges should be free to determine for themselves how an index might be modified in order to ensure that it is outside of the definition of a narrow-based security index by the end of the grace period.

C. Proposed Exclusion from the Definition of Narrow-Based Security Index during the First 30 Days of Trading

Q5 The Commissions have proposed rules that would provide an exclusion from the definition of a narrow-based security index, for an index that is broad-based when trading begins, but that becomes narrow-based within the first 30 days of trading. Proposed CFTC Rule 41.12 and Proposed SEC Rule 3a55-2. The CBOT appreciates the Commissions' attempt to provide an appropriate exclusion so that futures on such an index would not immediately become security futures. However, the exclusion, as defined by the Commissions, would only allow an index to continue trading as broad-based, if it would have been broad-based, had it been in existence, on each day of the six months preceding the first day of trading. Since an exchange would not want to chance an abrupt change of the applicable legal requirements, this rule effectively means that before an exchange could launch a futures contract based on a broad-based index, it would have to monitor the index on a daily basis during the six months prior to launch to ensure that it was broad-based on each day during that period.

The CBOT believes that a six-month time frame is too long to provide any meaningful relief, and it would raise serious practical problems. An exchange desiring to launch a contract as broad-based could not do so with any comfort, without first monitoring the index components on a daily basis for an indefinite period of time until the index is determined to be broad-based on each day of an uninterrupted period of six months. Aside from the sheer burden of having to perform the required daily calculations, this would make it impossible to properly plan the launch of any contract because the exchange would have to undertake all of the necessary preparations, including public announcements, without any assurance until the eve of the launch date that the contract had, in fact, been broad-based for every day during the preceding 6 months, such that it would remain a broad-based contract, in the event that it should fall within the definition of a narrow-based contract within the first 30 days of trading. The CBOT would

suggest that the Commissions consider adopting an approach similar to that which is applicable after a contract begins trading, i.e., if a contract is not a narrow-based contract for more than 45 days during the three-month period prior to the start of trading, it should not be considered to be a narrow-based contract during the first 30 days of trading. Such an approach would permit exchanges to reasonably prepare for the launch of a new contract, while allowing for a little unanticipated slippage in meeting the broad-based requirements on every single day for an extended period prior to launch.

In addition, as discussed above with regard to indexes that have changed their status after the statutory grace periods, it is important for the Commissions to permit continued trading in months that have open interest, at least for the purpose of liquidating positions, in the event that a broad-based index were to immediately become narrow-based because it failed to meet the 6-month, or any substituted, requirement.

It should also be noted that both the proposed CFTC regulations and the proposed SEC regulations define the "preceding 6 full calendar months" as a rolling 6-month period. Proposed CFTC Regulation 41.14 defines a "calendar month," in the context of computing the 3-month periods which are relevant in determining whether a narrow-based index has become a broad-based index, in a similar manner. However, proposed SEC Regulation 3a55-2 does not contain a comparable provision defining a calendar month, for purposes of the transition period when a broad-based index becomes a narrow-based index. The same definition should be incorporated into the SEC regulation.

III. Method for Determining Market Capitalization and Dollar Value of ADTV

Paragraph (a)(1) of proposed Rule 41.11 under the CEA and proposed Rule 3a55-1 under the Exchange Act set forth the method for determining the market capitalization of a security.

A. Market Capitalization

The Commissions' proposed measure of market capitalization is the product of the number of shares outstanding, as reported in the most recent quarterly or annual report filed with the SEC, and the volume-weighted price over the last 6 months. In response to **Q14**, this measure is non-standard and it is an imprecise measure of average capitalization. On any given date, the standard measure of capitalization is the number of shares outstanding times a representative price, e.g., the closing price. This is the measure used by Bloomberg, for example. The average capitalization over a specific period, such as the last six months, is the average of daily capitalizations during that period. As suggested in **Q16**, the number of shares used to calculate capitalization should be adjusted for corporate events affecting the number of outstanding shares of a security that occur after the issuer has filed its most recent quarterly or annual report with the SEC. Data vendors such as Bloomberg routinely perform such adjustments.

B. Dollar Value of Average Daily Trading Volume ($ADTV)

The Commissions' proposed definition for $ADTV is the average daily trading volume of the

security over the preceding six months times the average price of the security over the preceding six months. Using the proposed definition of the average price as the volume-weighted price, the $ADTV is then:

$$(\Sigma N_t) / T) \times (\Sigma N_i P_i) / (\Sigma N_i)$$

where N_t is the number of shares traded on date t, T is the number of days in the preceding six months, N_i is the number of shares traded at price P_i, and $(\Sigma N_i P_i) / (\Sigma N_i)$ is the average, i.e., the volume-weighted price. Note that this formula can be expressed as the average of daily dollar values traded as:

$$(\Sigma N_i P_i) / T$$

This is because $\Sigma N_t = \Sigma N_i$. Thus the $ADTV, as defined above, reduces to the definition of $ADTV suggested in **Q21**. In response to **Q20** and **Q28**, this measure is standard and intuitive. Calculating the $ADTV using the average closing price instead of the volume-weighted price would yield an unconventional and less accurate measure of average value traded. In response to **Q22** and **Q23**, the CBOT believes that the ADTV of American Depository Receipts ("ADRs") should be included in the calculation of the $ADTV, the average price of ADRs, on a proportional basis, should be considered when determining the average price of a security, and ADRs should be considered registered under Section 12 of the Exchange Act, if their underlying securities are so registered, for the purpose of the exclusion from the definition of a narrow-based security index contained in Section la(25)(B)(i) of the CEA and Section 3(a)(55)(C)(i) of the Exchange Act.

Q17, Q18, Q19, Q24, Q25, Q26, Q28, Q29, Q30 and Q31 The Commissions have solicited comment on whether they should permit exchanges to rely on independent calculations of the market capitalization and the $ADTV of a security by third parties, and whether any conditions should be imposed when a third party is used. In order to lighten the computational load imposed by the proposed rules, exchanges should be permitted to rely on all relevant summary data available from established data vendors. For example, Bloomberg supplies standard measures of market capitalizations and historical averages of $ADTVs for individual stocks. The average six-month $ADTV of an individual stock can be downloaded in one step and it is exactly the measure obtained when calculating $ADTV from a volume-weighted price average. **Q28** asks whether the average price input in the calculation of $ADTV should be the average closing price instead of the volume-weighted average price. In light of the above, it should not, both for conceptual and practical reasons.

In section (b)(2)(ii) of proposed CFTC Rule 41.11 and section (b)(2)(ii) of proposed SEC Rule 3a55-1, the Commissions propose an alternative definition of average price to be used strictly as an input in the computation of $ADTV. The average is "a non-volume-weighted average price" equal to the sum of all transaction prices divided by the total number of transactions. In response to **Q31**, the $ADTV implied by this definition yields a biased measure of average daily dollar

value traded because it assigns equal weights to all traded prices, regardless of the number of shares traded at those prices. Furthermore, computing the $ADTV based on this measure would require more work than computing the $ADTV based on the volume-weighted average price because the relevant data cannot be readily downloaded from Bloomberg.

IV. Conclusion

The CBOT believes the touchstones that the Commissions should bear in mind in crafting final regulations are simplicity (ease of understanding), administrative ease, and minimization of potential market disruption. The suggestions offered in this letter, we believe, would assist the Commissions in accomplishing their ultimate public policy objectives with greater simplicity, less administrative burden, and reduced potential for market disruption. We stand ready to work with the Commissions to achieve these goals.

Sincerely,

David J. Vitale