

## Appendix B

### Proposed New Broad-Based Security Index Definitions

**Background:** Pursuant to Section 2(a)(1)(C)(ii) of the CEA, futures contracts on broad-based security indexes fall within the exclusive jurisdiction of the CFTC, as opposed to security futures on narrow-based security indexes, which are jointly regulated by the CFTC and the SEC.<sup>1</sup> The CFTC has developed four new broad-based security index definitions to be included in Section 1a of the CEA.<sup>2</sup> These new definitions relate to: (i) broad-based foreign security indexes; (ii) broad-based debt security indexes; (iii) broad-based foreign debt security indexes; and (iv) a general broad-based index definition. Also included is a conforming change to Section 2(a)(1)(C)(ii) to confirm that these indexes would be included within the CFTC’s exclusive jurisdiction. Accordingly, futures contracts on these broad-based indexes would fall within the long-standing exclusive jurisdiction of the CFTC, and would be traded solely pursuant to CFTC rules and regulations applicable to such transactions. Each of these four new proposed definitions is discussed below.

#### **1. Broad-Based Foreign Security Index:**

This proposed definition is based on a concept developed by CFTC staff in connection with earlier attempts to promulgate a joint broad-based foreign security definition with the SEC.<sup>3</sup> This proposed definition differs from the basic requirements of the domestic “narrow-based” definition (found in CEA Section 1a(25)(A)) in that it takes into account the generally smaller size and more concentrated nature of foreign markets. For example, the domestic “narrow-based” definition includes a concentration test for the five most heavily weighted securities and a significant volume requirement. If the “narrow-based” test were applied to foreign markets, it would catch several well-established broad-based foreign security indexes based on these volume and weighting requirements that Congress set for the U.S. equity markets, but clearly did not intend for other markets.

In order to ensure that appropriate broad-based foreign security indexes, including sector indexes, would qualify as broad-based indexes under the exclusive jurisdiction of the CFTC, the proposed definition:

- maintains the domestic 30 percent weighting requirement, and

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<sup>1</sup> The SEC and CFTC acknowledged CFTC exclusive jurisdiction over broad-based indexes in their Joint Order excluding certain security indexes from the definition of narrow-based security index under the CEA and the federal securities laws, 67 Fed. Reg. 38,941 (June 6, 2002) (“To distinguish between security futures on narrow-based security indexes, which are jointly regulated by the Commissions, **and futures contracts on broad-based security indexes, which are under the exclusive jurisdiction of the CFTC . . .**”) (emphasis added).

<sup>2</sup> These proposals do not contemplate any amendment to existing CEA definitions for “narrow-based” and “non-narrow-based” security indexes, provisions that are mirrored in federal securities laws.

<sup>3</sup> CFTC staff developed this concept pursuant to the mandate of the CFMA that the SEC and CFTC promulgate joint broad-based foreign security index rules. The SEC and CFTC acknowledged their obligation in this regard in their joint definitional security futures product release, 66 Fed. Reg. 44,489 at 44,502 (August 21, 2001) (“The Commissions recognize their obligation jointly to adopt rules or regulations that set forth the requirements that a future on a security index traded on or subject to the rules of a foreign board of trade must meet in order for the index to be excluded from the definition of narrow-based security index.”).

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- includes an additional weighting test (in lieu of the concentration and volume tests discussed above) that is tailored to the nature and size of foreign securities markets. These provisions ensure that no single security outweighs others in the index such that the stock dominates the index.

**Statutory Language:** Section 1a of the CEA (7 U.S.C. 1a) is amended by inserting at the appropriate places the following:

( ) BROAD-BASED FOREIGN SECURITY INDEX.—

(A) IN GENERAL.—The term “broad-based foreign security index” means any index in which the component securities in the index:

- (i) are issued by entities organized pursuant to the laws of a country other than the United States; and
- (ii) are issued by at least nine unaffiliated entities.

(B) SINGLE COMPONENT SECURITIES.—For purposes of complying with subparagraph (A), no component security in the index (or aggregate of affiliated component securities) may comprise more than 30 percent of the index’s weighting.

(C) INDEX WEIGHTING REQUIREMENTS.—The five highest weighted component securities in a broad-based foreign security index (or the aggregate of “affiliated component securities” in the index, as defined in subparagraph (D)), shall comprise:

- (i) no more than 60 percent of the index’s weighting; or
- (ii) no more than 80 percent of the index’s weighting if, in addition, the aggregate market capitalization of the component stocks in the index:
  - (a) averaged at least \$40 billion during the preceding 12 calendar months; and
  - (b) represent, on average, at least 50 percent of the total market capitalization of the underlying securities market.

(D) AFFILIATED COMPONENT SECURITIES.—For purposes of determining whether component securities in the index are “affiliated component securities” in the index, entities issuing component securities shall be deemed to be affiliated if 30 percent or more of each entity is under common control or ownership.

(E) GRANDFATHERED BROAD-BASED FOREIGN SECURITY INDEXES.—A broad-based foreign security index shall include any index that has received permission, in accordance with the requirements of section 2(a)(1)(C) of this Act, to be offered and sold to United States persons prior to the date of enactment of this paragraph.

## **2. Broad-Based Debt Security Index:**

The rationale for a separate broad-based debt security index definition is that the definition currently found in the CEA is an equity-based definition, and was not developed to accommodate debt securities. Unfortunately, debt security indexes will almost always be considered “narrow-based,” primarily due to the volume requirements included in the current “narrow-based” index definition. Accordingly, there should be a separate definition for debt security indexes. (Conversely, futures contracts on individual government securities have a long

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history of trading on organized exchanges under the CFTC's exclusive jurisdiction pursuant to CEA Section 2(c)(2)(A).)

In addition, until very recently there had been no centralized transaction reporting system for debt securities, making the required calculations under the current definition difficult, if not impossible. This also made it difficult accurately to assess the size of these markets, which precluded trading futures contracts on these indexes as broad-based indexes within the exclusive jurisdiction of the CFTC under the current statutory definitions. To address this issue, the proposed definition:

- requires that the index not be dominated by a single security by including a 30 percent weighting requirement applicable to individual debt issuers, intended to ensure that events specific to that entity would not have a disproportionate impact on the index.
- explicitly allows municipal securities to be included in the index. Although such securities are exempted from registration with the SEC, futures trading on such securities is permitted only in the form of a broad-based securities index. Due to the transaction reporting system issues noted above, it has been difficult to assess whether a debt security index including municipal bonds would be considered anything other than a narrow-based index under the current volume test. Accordingly, the proposed broad-based debt security index definition specifically includes municipal bonds.

**Statutory Language:** Section 1a of the CEA (7 U.S.C. 1a) is amended by inserting at the appropriate places the following:

( ) BROAD-BASED DEBT SECURITY INDEX.—

(A) IN GENERAL.—The term “broad-based debt security index” means any index in which:

- (i) the component securities in the index are debt obligations, as defined in section 2(a)(1) of the Securities Act of 1933 and in section 3(a)(1) of the Securities Exchange Act of 1934;
- (ii) the component securities (including municipal securities as defined in section 3(a)(29) of the Securities Exchange Act of 1934 on the date of enactment of the Futures Trading Act of 1982) in the index are issued by at least nine unaffiliated entities;
- (iii) the debt of a single entity issuing component securities in the index (or the aggregate of “affiliated component securities” in the index, as defined in subparagraph (B)), comprises no more than 30 percent of the index's weighting; and
- (iv) each component security in the index is registered pursuant to section 12 of the Securities Exchange Act of 1934 (15 U.S.C. 781).

(B) AFFILIATED COMPONENT SECURITIES.—For purposes of determining whether component securities in the index are “affiliated component securities” in the index, entities issuing component securities shall be deemed to be affiliated if 30 percent or more of each entity is under common control or ownership.

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### **3. Broad-Based Foreign Debt Security Index:**

Foreign debt security markets, like domestic debt security markets, are not accommodated by the current equity-based index definition in the CEA. Accordingly, the proposed definition for a broad-based foreign debt security index generally tracks the requirements of the proposed broad-based domestic debt security definition, with two exceptions:

- the inclusion of municipal securities in the proposed broad-based debt security index definition is not applicable to the broad-based foreign debt security index definition.
- the proposed broad-based foreign debt security index definition similarly provides for nine unaffiliated component securities, but it excludes certain foreign government securities from this requirement. The rationale for this exclusion is that certain foreign government debt is exempted from the SEC's registration requirements for the purpose of trading futures contracts on those securities in the United States. *See* Rule 3a12-8 under the Securities Exchange Act of 1934, 17 C.F.R. 240.3a12-8. Since such exempted securities individually could be the subject of a futures contract, there is no need for an index to require a minimum number of such securities.

**Statutory Language:** Section 1a of the CEA (7 U.S.C. 1a) is amended by inserting at the appropriate places the following:

( ) BROAD-BASED FOREIGN DEBT SECURITY INDEX.—

(A) IN GENERAL.—The term “broad-based foreign debt security index” means any index in which:

- (i) the component securities in the index are debt obligations, as defined in section 2(a)(1) of the Securities Act of 1933 and in section 3(a)(1) of the Securities Exchange Act of 1934, issued by entities organized pursuant to the laws of a country other than the United States;
- (ii) the component securities in the index are issued by at least nine unaffiliated entities; and
- (iii) the debt of a single entity issuing component securities in the index (or the aggregate of “affiliated component securities” in the index, as defined in subparagraph (B)), comprises no more than 30 percent of the index's weighting.

(B) AFFILIATED COMPONENT SECURITIES.—For purposes of determining whether component securities in the index are “affiliated component securities” in the index, entities issuing component securities shall be deemed to be affiliated if 30 percent or more of each entity is under common control or ownership.

(C) FOREIGN GOVERNMENT DEBT SECURITIES.—Foreign government debt securities designated as exempt securities pursuant to Rule 3a12-8 under the Securities Exchange Act of 1934, 17 C.F.R. 240.3a12-8, may be included in a security index defined in this paragraph, but shall not be required to comply with any of the requirements of subparagraph (A); futures and options on individual exempt foreign government debt securities shall be specifically permitted under this Act.

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### 4. Broad-Based Security Index:

The CFMA amended the CEA and the Securities Exchange Act of 1934 to provide that the agencies may jointly establish regulations regarding indexes that are not “narrow-based” for futures on indexes that are traded on or subject to the rules of a board of trade. CEA Section 1a(25)(B)(vi); Exchange Act Section 3a(55)(C)(vi). To date, the agencies have not developed “broad-based security index” definitions. To provide legal certainty to products and market participants in this area, the Commission believes it would be helpful to provide a general broad-based security index definition to clarify what products fall within the exclusive jurisdiction of the CFTC. The proposed definition includes references to the foreign broad-based security index definition, the debt security index definition, and the foreign debt security index definition, as discussed above. In addition, the proposed definition includes references to existing sections of Section 1a(25)—the statutory definitions of narrow-based and non-narrow-based indexes. Lastly, the CFTC has proposed a conforming amendment that would clarify the exclusive jurisdiction of the Commission over futures on broad-based security indexes.

**Statutory Language:** Section 1a of the CEA (7 U.S.C. 1a) is amended by inserting at the appropriate places the following:

( ) BROAD-BASED SECURITY INDEX.—

(A) IN GENERAL.—The term “broad-based security index” means an index that—

- (i) is a broad based foreign security index, a broad-based debt security index, or a broad-based foreign debt security index as defined in sections 1a( ), ( ), or ( );
- (ii) is not a narrow-based security index as defined in section 1a(25)(A);
- (iii) meets the requirements of sections 1a(25)(B)(i), (ii), or (iii); or
- (iv) meets the requirements of Commission rules, regulations or orders promulgated or issued in accordance with the provisions of section 1a(25)(B)(v).

(B) COMMISSION DETERMINATION.—The Commission may, by rule, regulation or order, include within the term “broad-based security index” any index or group of indexes that it determines meets the requirements of sections 2(a)(1)(C)(ii)(I) and (II).

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Conforming Statutory Language:

Section 2(a)(1)(C) of the CEA (7 U.S.C. 2(a)(1)(C)) is amended in subsection (ii) by: 1) inserting “that is a broad-based security index, including any broad-based foreign security index, broad-based debt security index, or broad-based foreign debt security index” after “(or any interest therein or based upon the value thereof)”; and 2) in subclause (III), deleting “shall not constitute a narrow-based security index” and inserting in its place “shall constitute a broad-based security index.” As amended, subsection (ii) would read as follows:

- (ii) This chapter shall apply to and the Commission shall have exclusive jurisdiction with respect to accounts, agreements (including any transaction which is of the character of, is commonly known to the trade as, an ``option," ``privilege," ``indemnity," ``bid," `offer," ``put," ``call," ``advance guaranty," or ``decline guaranty") and transactions involving, and may designate a board of trade as a contract market in,

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or register a derivatives transaction execution facility that trades or executes, contracts of sale (or options on such contracts) for future delivery, of a group or index of securities (or any interest therein or based upon the value thereof) that is a broad-based security index, including any broad-based foreign security index, broad-based debt security index, or broad-based foreign debt security index: *Provided, however,* That no board of trade shall be designated as a contract market with respect to any such contracts of sale (or options on such contracts) for future delivery, and no derivatives transaction execution facility shall trade or execute such contracts of sale (or options on such contracts) for future delivery unless the board of trade or the derivatives transaction execution facility, and the applicable contract, meet the following minimum requirements:

(I) Settlement of or delivery on such contract (or option on such contract) shall be effected in cash or by means other than the transfer or receipt of any security, except an exempted security under section 3 of the Securities Act of 1933 or section 3(a)(12) of the Securities Exchange Act of 1934 as in effect on the date of enactment of the Futures Trading Act of 1982 (other than any municipal security, as defined in section 3(a)(29) of the Securities Exchange Act of 1934 on the date of enactment of the Futures Trading Act of 1982);

(II) Trading in such contract (or option on such contract) shall not be readily susceptible to manipulation of the price of such contract (or option on such contract), nor to causing or being used in the manipulation of the price of any underlying security, option on such security or option on a group or index including such securities; and

(III) Such group or index of securities shall constitute a broad-based security index.