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June 14, 2001

OFFICE OF THE SECRETARIAL

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Secretary  
Commodity Futures Trading Commission  
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RE: "File No. S7-11-01"/"Narrow-Based Security Indexes"

Dear Sir and Madam:

The **Montreal Exchange Inc.** (the "ME") welcomes this opportunity to comment on the proposals by the Securities and Exchange Commission ("SEC") and the Commodity Futures Trading Commission ("CFTC") in relation to administering the program for determining when the stock index underlying a futures contract will be deemed to be "narrow-based" and, as a consequence, subject to the new co-regulation regime created in the Commodity Futures Modernization Act of 2000 ("CFMA").

While the invitation for comments relates to the treatment of narrow-based stock index futures contracts on U.S. markets regulated by the CFTC or SEC, any decisions made by the agencies could impact the treatment of single-stock futures which also fall within the definition of "security future" under the CFMA. For that reason, the ME urges the SEC and CFTC to adopt the views expressed here in relation to share futures as well.

### **I. About the ME.**

The ME is Canada's only financial derivatives exchange. Among the futures contracts that it lists is a stock index futures contract based upon the S&P/TSE 60 stock index. The CFTC, without SEC objection, issued a no-action letter in favor of that product in 1999.<sup>1</sup> The ME also lists a variety of futures contracts on single stocks and on interest rate instruments.

The S&P/TSE 60 stock index is widely regarded as the benchmark index for the Canadian stock market and is used extensively to hedge against the systemic risks of that market as a whole. Annual volume in the S&P/TSE 60 index futures contract on the ME during the year

<sup>1</sup> See [1999-2000 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶28,050 (December 9, 1999).

2000 totaled 1,272,244 contracts. This product has not been found since its trading inception to have been the object of any attempted or successful manipulation.

Similarly, the single-stock futures listed on the ME can be used for risk management purposes. For example, they can be used to neutralize the impact of changes in the value of a particular common stock carried in a portfolio or to gain exposure to that stock prior to the time when funds are available to acquire it directly.

The ME is regulated by the Commission des valeurs mobilières du Québec ("CVMQ") with which both the SEC and the CFTC have a variety of cooperation agreements and information-sharing arrangements. The regulatory structure in Quebec has been held by the CFTC to be comparable to its own system and the ME's approved participants have been granted certain registration exceptions as a result.<sup>2</sup>

## **II. The Current Status of Foreign Security Futures.**

Despite the major reforms contained in the CFMA, U.S. participation in security futures listed on a foreign board of trade remains prohibited (as under Shad-Johnson) because the Commodity Exchange Act continues to confine lawful activity in these products to markets that are licensed by either the SEC or the CFTC.<sup>3</sup> Special measures will be required to correct this situation.

Even if the agencies act to lift the ban on foreign security futures use by U.S. investors, it is unclear how the CFTC and SEC will treat those products under the CFMA's standards or any other standards specially created for these foreign security futures. We understand, for example, that the SEC favors applying to foreign security futures the CFMA requirement that each and every security underlying a futures contract, including each component stock in the stock index even if listed on a foreign board of trade and comprised predominantly of securities issued by non-U.S. companies, must apply for and be registered with the SEC under section 12 of the Securities Exchange Act in order to qualify as a permissible security futures product. Many (perhaps all) foreign stock indexes and many foreign single-stock futures would be unable to meet that requirement; in that event, the foreign ban may remain.

Finally, as discussed in greater detail below, it must be remembered that the CFMA has largely deregulated security futures in the case of "eligible contract participants" or "ECPs." Whatever rules are fashioned by the CFTC and SEC for security futures listed on regulated exchanges *will not apply* to ECPs conducting transactions privately among themselves. ECPs may elect to trade, unregulated by either agency, whatever security futures they may wish.

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<sup>2</sup> See 54 Fed. Reg. 11179 (March 17, 1989), reprinted at [1987-90 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶24,410.

<sup>3</sup> See CEAct §2(a)(1)(C)(v) and Securities Exchange Act §6(h)(1).

As a result, it is critical that the regulated exchanges, foreign and domestic, not be precluded from offering products to ECPs that are readily available to them on an off-exchange basis.

### III. Specific Comments.

In particular, the ME wishes to address proposed CFTC Rule 41.13 and SEC Rule 3a55-3 which relate specifically to stock index futures contracts that are listed on boards of trade located outside the United States ("foreign boards of trade").

While the CFMA has effected many major changes to the Commodity Exchange Act ("CEAct"), it has retained the requirement that equity-based futures including a "security future" (which include a futures contract on single equity securities and on narrow-based stock indexes) must be traded on an exchange that is registered with or regulated by either the SEC or the CFTC. Because foreign boards of trade do not meet that requirement, their stock index futures contracts (broad-based as well as narrow) as well as their single-stock futures cannot be used by U.S. investors unless the agencies take special measures to override that prohibition.

The SEC and CFTC have proposed that, in determining whether the stock index futures contract of a foreign board of trade is "narrow-based," it will apply the standards that are used to make the same determination in regard to domestic stock and commodity markets. Comment has been invited, however, on whether foreign futures of this type should be judged differently and, if so, why.

#### *1. Numerical Standards Based Entirely On The Size and Nature of the American Markets Cannot Fairly Be Used To Gauge A Smaller Foreign Market or Economy.*

The ME questions whether numerical standards of any kind are a proper way to address investor protection concerns. While it is certainly far easier to use absolute cut-off numbers than to conduct an empirical examination of whether or not a danger actually exists, this approach can cause innocent casualties by ruling out some stock index futures contracts that are, beyond debate, both excellent hedging tools and free from market manipulation.

At a minimum, the CFTC and the SEC should be flexible when assessing a stock index futures contract listed on a foreign board of trade. In nearly all cases, the country's economy will be smaller than that of the United States. Ownership of corporate assets may be more concentrated, or a handful of major companies may account for most of the index's capitalization. Many nations are experiencing a gradual process of privatization where the government's shareholdings may still be significant. And average daily trading volume, in the aggregate as well as within any compartmentalized segment of the index, will likely fall far short of the volumes normally observed on a market like the New York Stock Exchange.

#### *2. Because Stock Index Futures Contracts Act As PROTECTION For U.S. Investors in Foreign Markets, More Investor Harm May Be Done By Restricting Their Use Than From Making Them Available Under Local Regulation and Supervision.*

Neither Rule 41.13 nor Rule 3a55-3 has an impact on use of foreign stock index futures contracts by any investor *except a U.S. person*. Venture capitalists, hedge funds, and institutional investors outside the U.S. can use these hedging devices freely in order to reduce their market risk; Americans may not.

The SEC and CFTC must weight the immediate costs of depriving U.S. investors of this risk-management tool against the theoretical possibility that those investors might be harmed some day by a market manipulation. We believe that the CVMQ, in collaboration with the ME, can minimize the latter risk while there is no way to avoid, or to remedy, market losses sustained as a result of being deprived of a readily available and effective hedging instrument.

*3. Restricting Access By U.S. Investors To Foreign Stock Index Futures May Conflict with Other Important U.S. Policies.*

We understand that it is U.S. public policy to encourage foreign investments by U.S. institutions because such activity helps to reduce poverty, achieve economic self-sufficiency, improve quality of life and strengthen both social and political systems. To interfere with the ability of U.S. investors to make foreign investments using available risk-management tools would tend to defeat that policy.

We urge the agencies to consult with other authorities of the federal Government before adopting restrictive actions on this subject.

*4. Setting Standards for Security Futures Offered by Regulated Foreign Exchanges Will Have NO Effect on Major Institutions That Can Trade Unqualified Security Futures Freely Among Themselves.*

It is unclear who is being "protected" by setting standards for foreign stock index futures. Most of the ME's patronage from U.S. sources comes from large institutions and wealthy individuals that qualify readily as "eligible contract participants" or "ECPs" under the CFMA and, as such, are entitled to conduct futures trading among themselves with minimal CFTC or SEC regulation, including futures transactions in any type whatsoever of stock or stock index.<sup>4</sup> Because they are able to engage in such conduct off-exchange, setting standards for exchange-based activity alone makes little regulatory or competitive sense; it harms the regulated markets without altering the wider choices available to most major participants in these products.

For this reason, we strongly urge the SEC and the CFTC to restore a level competitive playing field between the unregulated ECP arena, where no limits are imposed on permissible security futures, and the regulated exchanges. In the case of patronage on the ME by ECPs, access to the same security futures should be as open as in the over-the-counter ECP market.

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<sup>4</sup> See CEAct §§2(d) and (h).

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As noted in the second paragraph of this comment letter, many of the observations made here apply equally to the establishment of CFTC and SEC policies for single-stock futures. Certainly this is true with respect to the ECP market and the need for exchanges to be able to offer to ECPs whatever types of single-stock futures they can procure through private transactions.

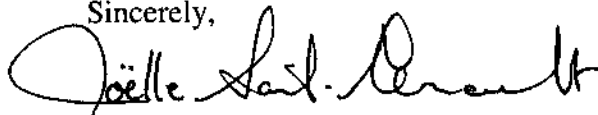
#### **IV. Conclusion.**

First, the CFTC and SEC need to determine a means whereby security futures contracts listed on foreign boards of trade can be lawfully offered to U.S. investors. The failure of the CFMA to overcome that impediment from prior law is disappointing. In addition, the agencies must accept foreign stock indexes for what they are, namely, an accurate reflection of the *local* market and the *local* economy. As long as a security future acts as an effective hedging tool and does not develop a history of manipulation, its benefits as a risk-management device would seem to greatly outweigh any remote risk of danger to investors, a contingency that can be substantially reduced in any event through effective governmental regulation in collaboration with the ME's self-regulatory program. The same observation applies to the risk management role that can be played by single-stock futures under the same local regulatory and self-regulatory scrutiny.

But there is no justification for restricting access to *any* security future in the case of entities and individuals qualifying as ECPs because they can replicate the same activity on an unregulated basis by simply doing the business between themselves. The exchanges, including the ME, must be allowed to compete in that sector.

We have welcomed this opportunity to share our views with the SEC and CFTC. We would be pleased to discuss any aspect of these comments with you if such a conversation or meeting is desired.

Sincerely,



Joëlle Saint-Arnault  
General Counsel and Secretary

cc. The Honorable Laura S. Unger  
The Honorable James E. Newsome  
The Honorable Isaac C. Hunt, Jr.  
The Honorable Barbara Pedersen Holum  
The Honorable Paul R. Carey  
The Honorable David D. Spears  
The Honorable Thomas J. Erickson