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COMMENT

June 18, 2001

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

Jean A. Webb
Secretary
Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street, N.W.
Washington, D.C. 20581

RE: "File No. S7-11-01"/"Narrow-Based Security Indexes"

Dear Sir and Madam:

Our client **SFE Corporation Limited ("SFE")** (formerly the Sydney Futures Exchange Ltd.) welcomes this opportunity to comment on the joint proposals of the Securities and Exchange Commission ("SEC") and the Commodity Futures Trading Commission ("CFTC") on the captioned subject above including proposed SEC Rule 3a55-3 and CFTC Rule 41.13 relating to treatment of "security futures" listed on foreign boards of trade.

I. Implementation of Policies for Foreign Boards of Trade.

We understand that the SEC and CFTC have agreed upon a plan of co-regulatory action for "security futures" to the extent that they are listed on United States securities or commodity exchanges, and must meet certain deadlines for implementing that plan, but that the Commodity Futures Modernization Act of 2000 ("CFMA") does not impose rigid requirements for the agencies to authorize activity by U.S. persons in security futures listed on foreign boards of trade. In fact, we understand that use by U.S. persons of security futures listed on foreign markets remains unlawful under the CFMA and that special measures will need to be taken by the agencies to legitimize them.

SEC Rule 3a55-3 and CFTC Rule 41.13, alone, would not solve this problem. They propose to adopt a joint policy applying the same standards to foreign-listed "narrow-based" stock index futures that will be used for equivalent domestic derivatives, but only if and when further action is taken to overcome the current bar against use of those products by U.S. investors. While we indicate below that the proposed Rules raise serious concerns, we also believe that the CFTC and SEC should expand their consideration of "security futures" on foreign markets in a manner that creates a comprehensive program allowing U.S. participation at the earliest practicable date.

II. Applying U.S. Standards to Foreign Stock Indexes Will Defeat the Protective Purpose of Those Futures Contracts.

It is universally acknowledged that stock index futures contracts, if properly designed, provide strong protection (a "hedge") against stock market exposure. In the case of a futures contract seeking to reflect the price behavior of a particular nation's stock market, this economic benefit relies heavily on how well the stock index tracks the *local* securities business.

In many countries, its stock market differs in character from the American model, at least at the present time. Aggregate market capitalization is likely to be far smaller than in the U.S.; the weightings in the index of particular stocks (*e.g.*, natural resources or telecommunications) may be higher; the process of privatizing traditionally nationalized businesses may by incomplete; and cross-ownership among the index's component companies may be significant. While these attributes may be viewed negatively when measured against the huge and diverse U.S. stock market, they are the reality of the local situation. Any stock index that fails to reflect diligently the true dynamic of its *own* stock market will fail as a product, will disappoint hedgers, and will be at least as susceptible to tampering as any other stock index futures contract.

For that reason, we urge the SEC and the CFTC to overcome the temptation to establish a litany of numerical minimums for foreign stock index futures and to utilize, instead, a pragmatic test having two basic components:

- *In economic terms, does the foreign stock index futures contract accurately reflect the underlying stock market?*

- *Is the quality of local stock market regulation sufficient to minimize the risk that the contract will be manipulated or may be used to manipulate any underlying stock?*

III. Since These Standards Do *Not* Apply To CFMA "Section 2(d)" Transactions, Imposing Them on the Exchanges Is Inappropriate.

We understand that a major purpose of the CFMA is to provide regulatory relief to institutional and sophisticated investors, especially when they confine their futures transactions to equally qualified counterparties and do so on a private (bilateral) basis. Section 2(d) largely excludes such futures activity from the CFTC's jurisdiction when trading in certain enumerated assets, including a "security" and a "security index." And section 3(a)(55) of the Securities Exchange Act makes clear that section 2(d) transactions are not "security futures" subject to the CFMA's co-regulation scheme.

We also understand that those who are qualified to invoke the section 2(d) exclusion, known as "eligible contract participants" (or "ECPs"), may trade bilaterally between each other futures on any individual security and on any stock index. The numerical thresholds set for exchange-traded equivalents do not apply. Nor do the minimum margin levels, SEC transaction fee, §12 registration requirement for each security, etc.

We are unable to discern any reason why the organized exchanges, which are subject to comprehensive regulation either in the United States or abroad, should be foreclosed from offering to ECPs any form of single-stock or stock index futures contract that those ECPs can acquire in section 2(d) transactions. In most jurisdictions, the outcome of submitting to regulation is *broader* rights than others enjoy; here, the reverse appears to be occurring.

IV. Policy for Narrow-Based Stock Index Futures Is Inexorably Linked With Policy For Single-Stock Futures.

While the CFMA is structured in a manner that might encourage the SEC and the CFTC to view single-stock futures as quite different from stock index futures, policies made for one will inevitably constrain the agencies' freedom to adopt different policies for the other. For example, if the template is to be that foreign "security futures" products must satisfy all demands being made on the domestic securities and commodity markets, the impact on the SFE and other foreign markets that list single-stock futures would be very adverse.

We understand that the U.S. markets will not be allowed to list futures contracts on individual securities unless the stock is registered with the SEC under section 12 of the Securities Exchange Act. The same may be true for each security in any narrow-based stock index futures contract that a domestic securities or commodity market may wish to offer. Were such a requirement imposed on the SFE

or other foreign futures markets, very few (if any) stock index futures contracts and only a limited number of single-stock futures contracts would be able to qualify.

A number of Australian multinational companies and banks have received §12 registration. However, registration is a costly process with follow-on responsibilities, and many other Australian companies have found no business necessity or advantage in doing so. We are confident that this same situation prevails in other non-U.S. countries. Equally important, it is not within the control of the SFE or any exchange whether or not a company elects §12 registration; in other words, it would not be a condition that is within the SFE's power to meet.

There is ample precedent within the international regulatory community for comity in the case of vetting processes. Australia and most other countries have their own form of "§12 registration" for domestic securities. Through collaborative effort, including IOSCO, those processes are growing more comparable. Where the CFTC and the SEC are comfortable that a foreign security is properly registered in its home jurisdiction, little is achieved by requiring a duplication of that effort in the United States. At a minimum, the SEC and CFTC should contemplate mandatory §12 registration only when they are convinced that the security cannot or will not be vetted appropriately in the home jurisdiction.

V. Impediments to Use of Foreign Hedging Markets Hurt U.S. Institutional Investors And Seem At Odds With Broader U.S. Policy.

We understand (and it is confirmed by the Australian experience) that U.S. institutional investors seek trading opportunities throughout the world on a regular basis. Such investments help to diversify U.S. portfolios and to take advantage of unique factors such as changes in currency rates. In addition, external investment of this nature helps to fuel the local economy, build needed infrastructure, strengthen financial institutions and systems, and improve quality of life.

Impediments to hedging against securities market risks in foreign countries are clearly at odds with the objectives of the investment community and, we understand, may be inconsistent with other American policies favoring deployment of U.S. private capital to other regions of the world for both economic and public policy reasons. Before adopting SEC Rule 3a55-3 or CFTC Rule 41.13, or any other regulations on this subject, we encourage the CFTC and the SEC to consult with other interested federal departments and agencies.

Please feel free to contact our counsel through any medium identified on the letterhead if you require or seek further information or clarification.

Sincerely,

Philip McBride Johnson

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