



**The American  
Stock Exchange**  
An NASD Company

**COMMENT**

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Michael J. Ryan, Jr.  
Executive Vice President and General Counsel

June 14, 2001

Via Overnight Delivery

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Securities and Exchange Commission  
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Washington, D.C. 20549

Ms. Jean Webb  
Secretary  
Commodity Futures Trading Commission  
1155 21<sup>st</sup> Street, N.W.  
Washington, D.C. 20581

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RECORDS SECTION

Re: Method for Determining Market Capitalizations and Dollar Value of Average Daily Trading Volume; Application of the Definition of Narrow-Based Security Index SEC Release No. 34-44288; File No. S7-11-01

Dear Ladies and Gentlemen:

The American Stock Exchange LLC ("Amex" or "Exchange")<sup>1</sup> is pleased to submit this comment letter in connection with the joint release of the Securities and Exchange Commission ("SEC") and the Commodity Futures Trading Commission ("CFTC"): "Method for Determining Market Capitalizations and Dollar Value of Average Daily Trading Volume; Application of the Definition of Narrow-Based Security Index" (the "Joint Release").<sup>2</sup> First, although not specifically covered in the Joint Release, we believe the release provides the opportunity for the Commissions to provide clarification of the term "single stock future" as it applies to futures contracts on shares of

<sup>1</sup> The Amex is a national securities exchange registered with the SEC pursuant to Section 6 of the Securities Exchange Act of 1934, as amended (the "1934 Act").

<sup>2</sup> See Securities Exchange Act Release No. 44288 (May 9, 2001), File No. S7-11-01 [RIN 3235-A113], 17 CFR Part 240; CFTC, 17 CFR Part 41 [RIN 3038-AB77].

exchange-traded funds (“ETFs”)<sup>3</sup> and trust-issued receipts (“TIRs”)<sup>4</sup> under The Commodity Futures Modernization Act of 2000 (the “CFMA”).<sup>5</sup> Second, we believe that proposed CFTC Rule 41.14 should be revised to permit a “grace period” of not less than nine (9) months, with extensions possible, and to allow trading other than “liquidation only” transactions during the wind-down period, for cases where a securities index future ceases to meet the “narrow-based” definition.

### **Statutory Background**

The CMFA by its amendment to the Commodity Exchange Act (“CEA”) and the Securities Exchange Act of 1934 (“1934 Act”) and other federal securities laws establishes a divided regulatory jurisdiction over securities related futures contracts. Jurisdiction over any “security future,” which is defined to mean any “contract of sale for future delivery of a single security or of a narrow-based security index ...” (collectively “narrow-based products”) is assigned jointly to the SEC and the CFTC.<sup>6</sup> The CFTC is given exclusive jurisdiction over any futures contract on any “group or index of securities” that does “not constitute a narrow-based security index.”<sup>7</sup> If a product is jointly regulated, it may be traded on either a SEC or CFTC regulated market which complies with the requirements of its principal regulator and makes a “notice” filing allowing it to be a limited purpose market place for purposes of the other commission’s jurisdiction. Thus, to trade “narrow-based” products, a national securities exchange, such as the Amex, would be required to satisfy SEC listing requirements as well as become a limited purpose designated contract market by making a notice filing with the CFTC. In contrast, if a product is not narrow-based (i.e. deemed to provide for future delivery of a broad-based index), the CFTC would have sole jurisdiction and a national securities exchange would be able to trade in it only if the exchange went through the full CFTC application and review process to become a designated contract market or a derivative transaction execution facility (“DTEF”). Furthermore, as pointed out by the Joint Release, this procedure would apply if the product, although initially a “narrow-based” were to later fail to meet the “narrow-based” definition.

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<sup>3</sup> Currently, the Amex lists and trades eighty-three (83) ETFs.

<sup>4</sup> Currently, the Amex lists and trades 17 HOLDRS products listed under our TIR standards.

<sup>5</sup> See Section 222 of the CFMA [Section 5 of the Commodity Exchange Act, as amended (“CEA”)].

<sup>6</sup> CEA §2(a)(1)(D)(i).

<sup>7</sup> CEA §2(a)(1)(c)(ii)(III).

### Single Security Futures

One of the often cited purposes of the CFMA is to provide legal certainty. This purpose would be furthered by the Commissions clarifying that certain instruments, particularly shares of ETFs and TIRs are single securities for purposes of the CFMA's "narrow-based products" definition. We believe that issuers, market participants and exchanges would benefit from the certainty that would be provided by a confirmation of this matter by the two Commissions.

An ETF refers to an investment company registered under the Investment Company Act of 1940, as amended (the "1940 Act"), that has its shares traded on a national securities exchange. Currently, ETFs are structured to track the yield and price performance of certain securities indexes, although in the future, ETFs may also be actively-managed. The majority of ETFs are registered under the 1940 Act either as unit investment trusts ("UITs") or open-end management investment companies (UITs and open-end management investment companies are collectively referred to as a "fund" or "funds"). Each such fund continuously offers and redeems shares in large aggregation amounts (50,000 shares) called Creation Units at a price established at the end of each business day based on the net asset value ("NAV") of its portfolio. The individual shares of the fund are listed and traded in a secondary trading market on a national securities exchange. These shares are separate securities registered under Section 12(b) of the 1934 Act and are subject to applicable exchange listing standards.<sup>8</sup> Accordingly, a fund share is traded like any other single security listed for trading on a national securities exchange.

TIRs are issued by a trust formed for the specific purpose of holding deposited shares for the benefit of its owners. For example, Holding Company Depository Receipts or "HOLDERS" are issued by a trust formed specifically for the purpose of issuing HOLDERS (the "HOLDERS Trust") and listed on the Amex under the TIR Rules.<sup>9</sup> As a result of no-action relief granted by the SEC's Division of Investment Management, the HOLDERS Trust is not a registered investment company under the 1940 Act.<sup>10</sup> Although investors in HOLDERS have many of the same rights as the owners of

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<sup>8</sup> See Amex Rules 1000 *et. seq.* (Portfolio Depository Receipts) and 1000A *et. seq.* (Index Fund Shares).

<sup>9</sup> The HOLDERS Trust is created by a depository trust agreement with a trustee, Merrill Lynch, Pierce, Fenner & Smith Incorporated (Initial Depositor) and other depositors and owners of the HOLDERS. See SEC No-Action Letter to Merrill, Lynch, Pierce, Fenner & Smith Incorporated dated September 3, 1999 (Merrill Lynch No-Action Ltr.).

<sup>10</sup> *Id.*

the underlying securities in the relevant HOLDRS Trust,<sup>11</sup> HOLDRS are separate securities registered under Section 12(b) of the 1934 Act and subject to applicable exchange listing standards.

Consequently, HOLDRS and other TIRs, trade like any other single security listed for trading on a national securities exchange. Further, HOLDRS may trade at a discount in the secondary market at prices lower than the net asset value of the underlying group of securities.

ETF shares and TIRs are each regulated and traded as single securities, and therefore, we submit, come within the definition of a "security future," and are *not* contracts for delivery of a securities index. ETFs are registered as management investment companies or UITs under the 1940 Act with their securities separately registered under Section 12(b) of the 1934 Act and subject to exchange listing standards. ETF shares do not represent a direct ownership interest of the underlying securities, but instead, are separately registered and traded shares in a single fund representing a direct ownership interest in the fund (ETF). Like mutual funds, an ETF holder cannot vote the underlying shares held by such ETF and may receive capital gain distributions, potentially resulting in economic results quite different than directly holding the actual underlying portfolio. Furthermore, with respect to ETFs, ownership of an ETF is not the same as ownership of the benchmark index. For example, a S&P Depository Receipt ("SPDR") is a separate security that tracks the performance of the Standard & Poor's 500 Index but is not the index itself.<sup>12</sup>

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<sup>11</sup> HOLDRS are issued by the trust and represent a beneficial ownership interest in the common stock of the specified underlying securities of the particular HOLDRS Trust. Beneficial owners have many of the same rights as they would have if they owned the underlying securities outside of the HOLDRS Trust. These rights include but are not limited to, the right to vote the common stock and receive dividends and other distributions on the underlying securities as well as receipt of all communications, proxy statements and other materials from the issuers of the underlying securities. However, an investor in HOLDRS is not free to receive or transfer the underlying securities. Rather the investor can gain access to the underlying securities only after cancellation of the related HOLDR, which requires surrender of the HOLDR during the trustee's normal business hours and payment of applicable fees, taxes or governmental charges, if any. Receipt of the underlying securities will occur within one (1) business day after the trustee receives the cancellation request.

<sup>12</sup> Although investment in an ETF may generally correspond to the price and yield performance of the underlying index or portfolio of securities, it is not the same as purchasing the underlying index or portfolio of securities. ETFs do not replicate the underlying benchmark index or group of securities, but instead, are initially set on a per share basis at a percentage of the underlying index or portfolio of securities. For example, SPDRs are 1/10<sup>th</sup> the value of the S&P 500 Index while the QQQ (Nasdaq-100 Index Tracking Stock) is 1/40<sup>th</sup> of the value of the Nasdaq-100. As of March 30, 2001, the "tracking error" as compared to the S&P 500 Index and Nasdaq-100 Index for SPDRs and QQQs was 0.01% and 0.02%, respectively. Therefore, owning the particular ETF is not the same as owning the underlying benchmark index or portfolio of securities.

Similarly, TIR shares generally and, in particular, HOLDRS, are single, separate securities registered under Section 12(b) of the 1934 Act and also subject to exchange listing standards. The Amex, in particular, has adopted separate listing standards for HOLDRS through adoption of the TIR rules.<sup>13</sup> An investor in a HOLDR has an ownership interest in the underlying securities held by the HOLDRS Trust, however, that ownership is indirect and undivided, and therefore, economically distinct as evidenced by the HOLDRS constitutive documents,<sup>14</sup> and by the fact that HOLDRS prices may vary from the value of shares held in the HOLDRS Trust. Further, HOLDRS are margined like individual stocks for customer accounts.

As a practical matter, the market has treated ETF shares and HOLDRS as separate securities for some time and each are actively traded as separate securities on national securities exchanges. For example, as of April 30, 2001, year-to-date average daily trading volumes for shares of the two most active ETFs – SPDRs and QQQs-- and aggregate HOLDRS were 11.3 million, 70.5 million and 5.11 million shares, respectively. Clearly, ETFs and HOLDRS function as separate securities with distinct and active trading markets. In addition, equity options are traded on shares of various ETFs and HOLDRS while a futures contract has yet to be developed on these securities. Of particular note is the absence of a futures contract based on SPDRs or QQQs. The lack of a futures contract on a variety of ETFs and HOLDRS suggests that the futures exchanges and related market participants have understood that shares of ETF and HOLDRS are separate securities.

The holder of an ETF contract also bears a risk that achieved performance of the ETF fund may not mimic exactly the performance of the benchmark index. As a security, ETF shares do not provide for “delivery” of the benchmark index, but reflect the shares of the underlying fund, which in turn is ultimately tied in value to the fund’s specific securities holdings, not the value of an index. Therefore, a HOLDR has even less of a connection than an ETF to a securities index. In addition, each HOLDR has its own separate pricing and trading characteristics apart from the underlying basket of securities held by the HOLDR Trust. The basket of securities, in turn, is completely distinct from any securities index (including an index that could in the future be conceived of) that happened to be comprised of the securities in the basket.

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<sup>13</sup> See Amex Rules 1200-1202.

<sup>14</sup> See Merrill Lynch No-Action Letter, supra note 9.

For all these reasons, we request that the Commissions confirm that shares of ETFs and TIRs (*i.e.* HOLDRS) which we registered as single securities under the 1934 Act, will also be classified as a single security for purposes of Section 3(a)(55) of the 1934 Act.

### **Narrow-Based Index Reclassification**

The Joint Release, in addition to proposing rules for determining market capitalization and dollar value of trading volume for purposes of applying the definition of "narrow-based" security index, also proposes a procedure for closing down markets when such an index ceases to be "narrow-based." This procedure has application to a national securities exchange that has become a limited purpose designated contract market by notice filing with the CFTC. Proposed CFTC Rule 41.14 provides that an index is "narrow-based" as long as it meets that definition for 45 days in any consecutive three (3) calendar months. However, if an index that was previously "narrow-based" ceases to be "narrow-based" (and is therefore "broad-based") for more than 45 days in the 3-month period, it would be deemed "broad-based" under the proposed Rule. After a "grace period" of three (3) months in which the index would continue to be deemed to be "narrow-based," the securities futures contract would be required to be wound down. Accordingly, the listing of new contract months would be prohibited with trading limited to liquidating only transactions.

We believe that the proposed Rule, if left unmodified, risks undue disruption and injury to investors and to any national securities exchange trading securities futures on an index that, may, due to no fault of the investors or the exchange ceases to be narrow-based.<sup>15</sup> More importantly, the proposal by providing an unreasonably short grace period and then limiting trading by all market participants (including specialists and market makers who provide market liquidity) to liquidating only transactions would reduce the liquidity of the securities futures contract market, and thereby, directly impose potentially significant costs on investors seeking to close positions. The mere risk that such an event could occur would impair the attractiveness of a narrow-based securities index

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<sup>15</sup> In contrast, a broad-based securities index future that becomes narrow-based after at least 30 days of trading is provided a 3-month grace period where in order to remain solely regulated by the CFTC, such designated contract market, DTEF or foreign board of trade would be required to change the composition of, or weightings of, securities in the index so that it is not narrow-based. Alternatively, such markets could notice register as a securities futures product exchange under Section 6(g) of the 1934 Act. *See* Section 202 of the CFMA. In cases where the broad-based securities index future has traded for less than 30 days, the proposed Rule calls for an exclusion from the definition of narrow-based security index if such index for an uninterrupted period of 6 months prior to the first day of trading would not have been narrow-based.

Mr. Jonathan G. Katz, Secretary  
Securities and Exchange Commission  
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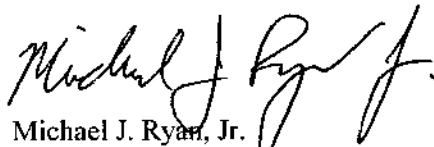
futures contract. Depending on the particular index, a national securities exchange such as the Amex, may also have very little influence or power to change or modify the composition of an index in order for it to remain narrow-based. Accordingly, we believe that a national securities exchange trading a narrow-based securities index futures contract should not be materially disadvantaged by a subsequent change in the index's classification to broad-based.

While CEA section 2(a)(1)(c)(iii) grants the CFTC discretion to determine that a stock index futures contract, although not conforming to the "narrow-based" definition, should be treated as a security future, we believe that this discretionary authority would not cure the identified inadequacies in the proposed Rule. Both investor protection and exchange business requirements call for the legal certainty of a well-crafted rule on this subject. We therefore urge both the SEC and CFTC to incorporate the following modifications into the final Rule. With respect to the "grace period," if an underlying index had been the narrow-based for at least 6 consecutive months prior to the initial trading in the related securities futures contract, we believe that there exists a strong presumption that the contract was listed in good faith and not in an attempt to evade CFTC jurisdiction. In such case, a grace period of at least 9 months should be allowed for a more orderly wind-down to trading or to permit the exchange to seek to qualify as a designated contract market so that the futures contract could continue trading. Furthermore, we also believe that it would be appropriate for the CFTC to give itself the flexibility to extend the grace period, particularly when an application for designation as a contract market is pending. We also assert that the "liquidating only" limitation on trading should be eliminated from the proposed Rule. At the very least, it is essential that professional liquidity providers, such as specialists and market makers, be allowed to continue to effect opening transactions through the remaining life of the contract, to foster liquidity and avoid harming investors who hold positions in the expiring contract. Otherwise, specialists and market makers will quickly flatten out their positions. Therefore, public customers would only be able to liquidate their positions in the unlikely event that another public customer with an opposing position were seeking to close-out their position at the same time.

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Thank you for this opportunity to comment on the Joint Release. If there are any questions or comments regarding this letter and related matters, please contact the undersigned at (212) 306-1200 or Jeffrey P. Burns at (212) 306-1822.

Sincerely,



Michael J. Ryan, Jr.  
Executive Vice President and General Counsel

cc: Hon. Laura S. Unger, Acting Chairman, SEC  
Hon. Isaac C. Hunt, Jr., Commissioner, SEC  
Hon. Paul R. Carey, Commissioner, SEC  
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