

**CHICAGO MERCANTILE EXCHANGE INC.**

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**COMMENT**

OFFICE OF THE SECRETARIAT

June 18, 2001

Ms. Jean A. Webb  
Office of the Secretariat  
Commodity Futures Trading Commission  
1155 21st Street, N.W.  
Washington, D.C. 20581

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

VIA FACSIMILE AND E-MAIL

Re: Commodity Futures Modernization Act of 2000 and Securities Exchange Act of 1934 - Narrow-Based Security Indexes, File No. S7-11-01, 66 Fed. Reg. 27560 (May 17, 2001)

Dear Ms. Webb and Mr. Katz:

Chicago Mercantile Exchange Inc. ("CME") is pleased to offer these comments on a proposal recently published by the Commodity Futures Trading Commission and the Securities and Exchange Commission ("Commissions") regarding rules designed to implement the definition of a Narrow-Based Security Index ("NBI") under the Commodity Futures Modernization Act of 2000 ("CFMA"). NBIs are classified as Securities Futures Products ("SFPs") and will be jointly regulated by the Commissions. CME supports a reasonable and consistent implementation of the definition of an NBI and the adoption of transition rules for those cases when a Broad-Based Security Index ("BBI") becomes an SFP and vice versa. Transition rules are a crucial part of the rulemaking, given the potentially drastic impact on market participants of a change in regulatory status of open positions.

While CME supports the objectives of the rulemaking proposals, the methodology can be improved. Our comments focus on means to improve the proposal.

**I. INTRODUCTION**

The Commodity Exchange Act ("Act") and the Securities Exchange Act of 1934 ("Exchange Act"), as amended by the CFMA in sections 1a(25) and 3(a)(55) respectively, contain identical definitions of an NBI. The primary test - found in sections 1a(25)(A) and 3(a)(55)(B) - establishes four criteria that characterize an NBI. The central criterion addressed

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by the proposed rulemaking is that "...the lowest weighted component securities comprising, in the aggregate, 25 percent of the index's weighting have an aggregate dollar value of average daily trading volume of less than \$50,000,000 (or in the case of an index with 15 or more component securities, \$30,000,000)...."<sup>1</sup> For indexes that are classified as NBIs by the primary test in 1a(25)(A) and 3(a)(55)(B), sections 1a(25)(B) and 3(a)(55)(C) provide six potential exclusions. The first potential exclusion requires in part that each component security of a suspect security index be "...one of 750 securities with the largest market capitalization..." and "...one of 675 securities with the largest dollar value of average daily trading volume..."<sup>2</sup> The second exclusion is for existing security index futures and futures options traded at designated boards of trade, which are excluded regardless of their composition and the level of underlying trading activity. The third exclusion is for domestic futures that have traded as BBIs for at least 30 days and have become NBIs for no more than 45 trading days in the previous three consecutive calendar months. Exclusion four allows the Commissions to jointly establish requirements for security index futures traded on foreign boards of trade. The fifth exclusion allows previously approved foreign-traded indexes to continue to trade for eighteen months, provided that any required conditions for approval continue to be met. Exclusion six allows the Commissions to jointly establish other exclusions by rulemaking for contracts traded on or subject to the rules of a board of trade.

With respect to making determinations according to the quantitative standards in the primary test and the exclusions, the CFMA requires that the dollar value of average daily trading volume ("ADTV") and market capitalization, where applicable, be calculated "...as of the preceding 6 full calendar months." The CFMA also requires that the Commissions jointly specify the methods for performing these calculations.

For indexes that have relied on the third exclusion to trade as BBIs but subsequently fail to do so, the CFMA allows a three-month grace period before they are regulated as SFPs. There is no parallel grace period in the legislation for a contract based on an NBI that becomes broad based and therefore subject to the exclusive jurisdiction of the Commodities Futures Trading Commission ("CFTC"). Likewise, the CFMA provides no slack for a futures contract on a BBI that becomes an NBI during the first 30 days of trading.

All of the issues noted above are treated in the Commissions' proposal. With respect to the calculation of ADTVs, the proposed rules require for every non-grandfathered security index on which futures trade in the United States - or are sold to U.S. citizens - that calculations be performed every day to determine the ADTV for every component security over the previous six months. With respect to the calculation of the dollar value of ADTV, the proposed rules require that ADTV be multiplied by the average price of the security over the previous six months. The

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<sup>1</sup> The others are that the index have more than 9 component securities, that no security account for more than 30% of the index's weighting and that the 5 highest weighted securities account for no more than 60% of the index's weighting.

<sup>2</sup> These two size tests apply only to indexes with 9 or more component securities, none of which can account for more than 30% of the index's weighting, and each of which is registered pursuant to section 12 of the Exchange Act.

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average price is to be calculated as the weighted average price of every transaction during the previous six months, except that for the purpose of calculating the dollar value of ADTV a simple average may be calculated instead, but with the hurdle amount raised by ten percent.

The dollar value of ADTV must be calculated daily for the component securities representing 25% or less of the index under the proposed rules. For example, if the 5 lowest-weighted securities represent 22% of the index and the 6 lowest-weighted securities represent 25.01% of the index, then under the proposed rules only the 5 lowest-weighted securities could be used to tally the dollar value of ADTV.

If the ADTV test – or any of the other three components to the primary definition of an NBI – is failed, then – pursuant to the first exclusion – it may be necessary to calculate market capitalization as well as the dollar value of ADTV for every security in the index. Under the proposed rules market capitalization is to be calculated as the product of the dollar value of ADTV – using the weighted average definition – and the number of shares outstanding.

The proposed rules reflect the three-month grace period in the legislation granted to a BBI that falls to SFP status. The proposed rules also contain a reciprocal grace period – not found in the CFMA – which requires an NBI that has become a BBI to wait three months before exclusive CFTC jurisdiction would apply. The Commissions have also proposed to provide a provisional grace period for futures whose underlying indexes become NBIs during the first 30 days of trading.

## **II. NEED FOR ALTERNATIVE EXPEDITED CALCULATION PROCEDURES**

Clearly there is a need to follow the strictures of the CFMA in separating NBIs from BBIs. The proposed rules, or procedures like them, may be necessary in cases where there is a close call.<sup>3</sup> In other cases, however, the proposed rules potentially would require enormous numbers of logically unnecessary calculations. For example, consider an index comprising the 100 largest publicly traded corporations in the world. Every one of the securities in the lowest-weighted 25% of that index would likely have highly active trading activity, with tens of thousands of transactions occurring every day and with a dollar value of ADTV that greatly exceeded the \$30 million requirement for an index with fifteen or more components. Yet an exchange that listed futures on that index would have to perform millions of pointless calculations every day to follow the proposed rules.

As an alternative, CME believes that an exchange should be able to apply logical relationships to minimize the calculation burden. For example, if for the lowest weighted security in an index the product of the ADTV and the lowest traded price during the previous six

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<sup>3</sup> A procedure likely to produce virtually identical results that is suggested as an alternative in the Commissions' request for comments is to use the average closing price over the previous six months. Use of the midpoint of the high and the low for the day would also reduce computational burdens significantly. Neither alternative approach would materially affect the determination of whether a security index was an NBI.

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months is greater than the hurdle value, then the dollar value of ADTV will necessarily be greater than the hurdle value as well. A similar relationship exists if daily lowest traded prices are used and similar logic could be used to aggregate the lower-weighted securities in an index. Similar reasoning can also be applied to the calculation of market capitalization.

Under this alternative "bottom up" approach an exchange would have the ability to choose the least burdensome way of satisfying the criteria in the CFMA. CME strongly recommends that such flexibility be granted.

### **III. APPLICATION OF THE 25 PERCENT CUTOFF**

As noted above, the Commissions have taken an unusual approach to applying the "25% over \$50 million" criterion. The issue arises because it is unlikely to be the case that the aggregate weight of the lowest weighted securities exactly equals 25% of the index. That is, there will usually be a deficiency or excess from 25% when the weights of an integral number of securities are aggregated. For an example of the implications of the proposed rules, consider a security index with ten equally-weighted component securities. The dollar value of ADTV used to determine NBI status would be calculated using only two securities, because a third security would bring the aggregate weight to 30%.<sup>4</sup> In that case under the proposed rules only 20% of the index would have to have a dollar value of ADTV of \$50 million, not the 25% specified in the legislation.<sup>5</sup>

In this 10-security example, there is a deficiency of 5% when two securities are aggregated and an excess (also 5% in this case) when three securities are aggregated. The Commissions have proposed to ignore the deficiency and only aggregate the dollar value of ADTV for the securities that constitute less than 25% of the weight in the index.<sup>6</sup> A more natural approach – and a more literal interpretation of the CFMA – would be to pro-rate the dollar value of ADTV of the "bridge" security according to the share of the deficiency in its weight in the index. In the example above 50% of the dollar value of ADTV for the bridge security would be included in the calculation.

Apart from being an unnatural and biased interpretation of the CFMA, the proposed rules have a paradoxical element. Consider again an index with ten equally-weighted components. As noted above, under the proposed rules the dollar value of ADTV would be based upon two securities accounting for 20% of the weight in the index (the two with the lowest dollar values of ADTV). Suppose that the index provider tried to broaden the index by adding another security similar to the ten in the index, creating an index with eleven equally-weighted components. Intuition would suggest that the index would become more broad based. The security with the third-lowest dollar value of ADTV still would be the bridge security, however, since the

<sup>4</sup> Such an index would satisfy the other three requirements for a BBI.

<sup>5</sup> It is possible to construct an example where only 16% of the weight in an index would have the burden of attaining a dollar value of ADTV of \$50 million.

<sup>6</sup> Proposed rules 41.11(b)(4) under the Act and 3a55-1(b)(4) under the Exchange Act.

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aggregate weight of the three lowest-weighted securities would now be 27.3%. Therefore the dollar value of ADTV criterion would have to be met by two securities with only 18.2% of the weight in the index under the proposed rules. That is, an attempt to "broaden" that index by adding a similar security would not make it more likely to be classified as a BBI!

It seems unlikely that such anomalies were what the authors of the CFMA had in mind. Therefore, CME requests that the proposed rules be revised to allow inclusion of the appropriately pro-rated portion of the bridge security in the calculation of the dollar value of ADTV. Then the "25% over \$50 million" criterion would be consistently applied. Otherwise it is likely that truly broad-based indexes will be unfairly categorized as NBIs because of a quirk in the rules.

#### **IV. GRACE PERIODS FOR TRANSITIONS IN REGULATORY STATUS**

The transition in status from a BBI to a SFP or vice versa will possibly be a disruptive event, given differing treatment of margins, customer funds, etc. under the two alternate regulatory regimes. Congress anticipated this and allowed for a three-month grace period after a BBI becomes a SFP before it must be regulated jointly by the Commissions. The Commissions have correctly and straightforwardly reflected that in their proposed rules.

Congress made no provision for a grace period in the opposite case however. That is, should a NBI become a BBI the joint regulatory structure falls away leaving the CFTC as the exclusive regulator of futures on that index. This is likely to be a disruptive event, especially if the futures contract is traded on a securities exchange, and the Commissions are correct to provide a grace period for the transition in that case.<sup>7</sup> If the futures contract is traded on a Designated Contract Market or Derivatives Trading Execution Facility however, the transition may be somewhat less disruptive. In that circumstance CME recommends that the listing exchange be given the choice of removing the futures from joint regulation sooner than three months from the switch to being a BBI. The listing exchange would then have the freedom to choose the course that was less disruptive for market participants.

#### **V. PROVISION OF GRACE PERIOD FOR INFANT BBI FUTURES**

The CFMA and the proposed rules provide an exclusion from SFP status for futures on security indexes that have been listed for trading for at least thirty days and the underlying index has not failed the BBI criteria for more than 45 days in the previous three months. A strict reading of the legislation would apparently imply that futures on security indexes that have traded for less than thirty days would immediately become futures on NBIs if they failed to meet the criteria on any day. The Commissions have wisely proposed to provide a parallel grace period for such infant futures contracts if a certain condition is met.<sup>8</sup> The condition is that

<sup>7</sup> Alternatively, the securities exchange and its index provider could make changes to the index to prevent it from being categorized as a BBI.

<sup>8</sup> Proposed rules 41.12 under the Act and 3a55-2 under the Exchange Act.

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“...such index would not have been a narrow-based security index on each day of the preceding 6 full calendar months prior to the commencement of trading of such contract.”

CME believes that this condition is reasonable and desirable in spirit but ambiguous in application. The fourth criterion for BBI status requires a calculation of the dollar value of ADTV over the previous 6 months. Do the Commissions intend that the calculations be done for the previous 6 months for each day in the 6 months before the commencement of trading? Such an interpretation would imply calculating the dollar value of ADTV for a full year prior to the commencement of trading. CME objects to such an interpretation as being overly onerous for the purpose intended, but would support an interpretation that the dollar value of ADTV must meet the hurdle value separately for each day in the 6 months prior to the commencement of trading.

## **VI. PROPOSED TREATMENT OF FOREIGN-LISTED SECURITY INDEXES**

Prior to the enactment of the CFMA domestic boards of trade complained that there was an unfair regulatory arena, with foreign boards of trade often allowed to market competing products in the U.S. under less rigorous regulation than that provided by the CFTC. Many regulated foreign boards of trade complained that to the extent CFTC and/or SEC regulations applied to them they were subject to unfair dual regulation.

Congress did not distinguish between foreign and domestic securities or foreign and domestic boards of trade when they defined an NBI in the CFMA. Instead, as part of the NBI exclusions Congress stipulated that the Commissions establish requirements for security futures contracts trading on or subject to the rules of a foreign board of trade and to grandfather for eighteen months foreign-listed security futures contracts already authorized for sale in the U.S.<sup>9,10</sup> The Commissions were given one year from the enactment of the CFMA to establish such requirements. The proposed rules would treat foreign-listed futures on security indexes as if the futures were listed on a domestic board of trade for the purposes of determining whether the underlying security index is an NBI. That is, the foreign board of trade would have to perform the same daily calculations involving all transactions in every security in the index on every day in the preceding six months. Apparently, if the underlying security index became an NBI, there would be a three-month grace period before the foreign board of trade would have to have registered with either the CFTC or the Securities and Exchange Commission (“SEC”) – and have notice registered with the other agency – in order to continue offering the affected product in the U.S.

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<sup>9</sup> One other exclusion applies only to indexes comprised of securities registered under section 12 of the Exchange Act.

<sup>10</sup> The U.S. regulatory status of futures contracts traded on foreign boards of trade other than Securities Futures Products would appear to be unchanged, with CFTC jurisdiction over such contracts limited by section 4(b) of the Act.

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CME believes that the issues surrounding the application of the CFMA to security index futures traded on foreign boards of trade are longstanding, complicated, and difficult. To the extent that the proposed rules force foreign-listed security index futures to fit into the same regulatory framework as like domestic products, CME agrees with the proposed rulemaking. To the extent that foreign boards of trade and participants in foreign markets consider the proposed rules an unwarranted, unfair, and costly intrusion in their affairs the proposed rules have the potential to be very controversial and may disrupt and prolong the rulemaking process. Noting that the Commissions have been granted one year to resolve the issues surrounding the treatment of foreign boards of trade, CME recommends that proposed parts 4.13 under the Act and 3a55-3 under the Exchange Act be separated from the rest of the proposed rulemaking.

#### **VII. DEFINITION OF "THE PRECEDING 6 FULL CALENDAR MONTHS"**

The CFMA requires that the dollar value of ADTV and market capitalization be calculated "...as of the preceding 6 full calendar months." One of the potential exclusions from SFP status afforded a security index requires that the index be a NBI for "...no more than 45 business days over 3 consecutive calendar months. The exclusion under that provision would provide a grace period of "...the 3 following calendar months." CME believes that by the phrases "full calendar month" and "calendar month" Congress likely meant the month-long periods that are referred to as "January", "February", "March", etc., as that is the common usage. A natural conclusion, based on the consistency with which Congress used the phrase "calendar month", would be that the test for SFP status was meant to be applied monthly.

In contrast to common usage, the Commissions propose to define the preceding 6 full calendar months, with respect to a particular day, as "...the period of time beginning on the same day of the month 6 months before and ending on the day prior to such day." The clear motive for doing so is to allow for meaningful daily testing of the SFP status of security indexes.<sup>11</sup> The Commissions are correct in observing that a calculation of the dollar value of ADTV based on 6 full calendar months of data would only change monthly. Similarly, the "45-over-3" calculation would only change monthly if the dollar value of ADTV only changed monthly. Those observations would be perfectly consistent with a monthly test for SFP status, however. With a monthly calculation, if an index failed the dollar value of ADTV test two months in a row, or two months out of three, it would have been an NBI for approximately 45 trading days in the preceding three-calendar-month period and would be regulated as a SFP after the 3-month grace period. Thus the result of monthly calculations would closely correspond to the literal meaning of the CFMA.

CME believes that monthly testing – as opposed to daily testing – for SFP status is appropriate for the following reasons: (1) It is consistent with the plain meaning of the CFMA. (2) It would dramatically reduce the data gathering, calculation, and paperwork burden on exchanges. (3) It would reduce the paperwork and review burden on the Commissions. (4) It

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<sup>11</sup> The CFMA is silent on the frequency with which the test is to be applied.

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would not affect the regulatory status of futures on security indexes in any material way. That is, the probability that a particular security index would be a SFP on any particular day in the future would not be affected. (5) Since the timing of transitions between SFP and BBI status would be more predictable, it would be less disruptive to the marketplace. Therefore CME strongly recommends that the definition of the "preceding 6 full calendar months" be conformed to normal English usage and that the test for SFP status of security indexes be required to be performed on a monthly basis.

## **VIII. RESPONSES TO COMMISSIONS' SPECIFIC QUESTIONS**

### **A. DEFINITION OF AN NBI**

#### **I. INDEXES EXCLUDED FROM THE DEFINITION OF AN NBI**

1. See CME response to Question 2.
2. CME believes that in the interest of efficiency and consistency the Commissions should jointly determine the Top 750 securities with the largest market capitalization and the Top 675 securities in terms of dollar value of ADTV. Because exchanges will be required to test whether the securities underlying a security index futures contract passed the tests on a daily basis under the proposed rules, the lists should be prepared daily. Otherwise they would not be useful in meeting the letter of the criteria in the proposed rules.
3. See CME response to Question 2.

#### **II. A FUTURES CONTRACT ON A BBI THAT BECOMES NARROW BASED**

##### **A. STATUTORY GRACE PERIOD**

4. CME believes that because exchanges will be required to monitor the narrowness of underlying security indexes on a daily basis, they will have ample opportunity under the proposed rules to work with their index providers to make any adjustments to avoid falling into SFP status, if that is what they desire to do. Prescriptive regulatory requirements would be difficult to design and unlikely to anticipate real-world situations that might arise.

##### **B. PROPOSED EXCLUSION FROM THE DEFINITION OF AN NBI DURING FIRST 30 DAYS OF TRADING**

5. See Section V above.

#### **III. PROPOSED RULE FOR FUTURES CONTRACTS TRADED ON OR SUBJECT TO THE RULES OF A FOREIGN BOARD OF TRADE**

6. See Section VI above.
7. See Section VI above.
8. See Section VI above.
9. See Section VI above.
10. See Section VI above.
11. See Section VI above.
12. See Section VI above.
13. See Section VI above.

### **B. METHOD FOR DETERMINING MARKET CAPITALIZATION AND DOLLAR VALUE OF ADTV**

#### **I. DETERMINING MARKET CAPITALIZATION**

14. See Section II above.



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15. CME recommends that exchanges be allowed to rely upon information provided by index providers, data vendors, and other third parties to determine numbers of shares outstanding and changes therein.
  16. See CME response to Question 15.
  17. Yes, third-party calculators should be allowed. No, they should not be restricted.
  18. CME believes that the Commissions should allow flexibility by third parties (and exchanges) in the methodologies used to calculate ADTV, average price, and market capitalizations.
  19. CME believes that the Commissions should not regulate third-party providers of market information.
- II. DETERMINING DOLLAR VALUE OF ADTV**
20. See Section II above.
  21. See Section II above.
  22. CME agrees that ADRs are the proper basis for calculating the ADTV and average price of securities that trade in the form of ADRs.
  23. Yes, ADRs should be considered to be registered pursuant to Section 12 of the Exchange Act.
  24. See CME response to Question 17.
  25. See CME response to Question 18.
  26. See CME response to Question 19.
- III. DETERMINING ADTV**
27. See Section II above.
- IV. DETERMINING AVERAGE PRICE**
- A. BASIC DEFINITION**
28. See Section II above.
  29. See CME response to Question 18.
  30. See CME response to Question 19.
- B. EXCEPTION PERMITTING USE OF NON-VOLUME-WEIGHTED AVERAGE PRICE FOR CERTAIN CALCULATIONS**
31. CME believes that a simple average price is likely to produce substantially identical results to a volume-weighted average price. Given that the additional computational burden of calculating the latter is minimal and that using the former would incur a ten-percent penalty, CME believes that exchanges are unlikely to use the alternative.
- V. COMPONENT SECURITIES OF AN INDEX THAT TRADE IN FOREIGN MARKETS**
32. CME agrees with the Commissions' proposed treatment of securities that trade in foreign markets.
  33. CME does not object to the use of the FRBNY noon buying rate to convert foreign prices to dollars.
  34. CME does not object to the proposed treatment of trading days.
  35. CME has no other issues with respect to foreign trading in the context of the proposed rules.
- VI. DETERMINING "THE PRECEDING 6 FULL CALENDAR MONTHS"**
36. See Section VII above.

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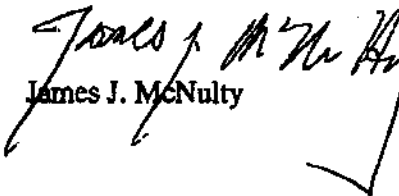
**VII. THE LOWEST WEIGHTED 25% OF AN INDEX**

37. See Section III above.

**VIII. CONCLUSION**

CME appreciates the opportunity to comment on the proposed rules and hopes that its opinions and recommendations will be considered seriously by the Commissions.

Respectfully submitted,



James J. McNulty

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