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Goldman Sachs

COMMENT

July 18, 2001

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RECORDS SECTION

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

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

Re: Method for Determining Market Capitalization and Dollar Value of Average Daily Trading Volume; Application of the Definition of Narrow-Based Security Indexes, 66 Fed. Reg. 27560 (May 17, 2001) SEC File No. S7-11-01 ("Proposed Rules")

Dear Ms. Webb and Mr. Katz:

On behalf of The Goldman Sachs Group, Inc. and its subsidiaries, including Goldman, Sachs & Co. (referred to herein collectively as "Goldman Sachs"), we are pleased to comment on the rules that the Commodity Futures Trading Commission ("CFTC") and the Securities and Exchange Commission ("SEC") (collectively, the "Commissions") have proposed to implement certain provisions of the Commodity Futures Modernization Act of 2000 ("CFMA") relating to "security futures products" as that term is defined in the CFMA.* Our comments focus on the Commissions' proposal as it relates to security index futures contracts that are traded on or subject to the rules of exchanges and boards of trade located outside of the United States the component securities of which are non-U.S. securities ("foreign security index contracts"). Specifically, our comments address the Commissions' proposal to apply the same definition for a narrow-based foreign security index contract as the CFMA requires for U.S.

* CFMA § 101(7).

index futures contracts (the "U.S. Statutory Criteria"). In addition to the U.S. Statutory Criteria, Goldman Sachs supports the alternative regulatory standard for foreign security index contracts set forth in Appendix A to this comment letter. Goldman Sachs has reviewed the comment letter of the Futures Industry Association ("FIA") and endorses both the comment letter and its proposed regulatory standard which is identical to our Appendix A.* We recognize that criteria other than this proposed standard may achieve the goal of allowing a wider range of foreign security index contracts consistent with the public interest, and we would applaud any efforts to implement additional criteria consistent with that goal.

Goldman Sachs is a full service investment bank. It is registered with the CFTC as a futures commission merchant ("FCM"), commodity trading advisor and commodity pool operator. It is registered with the SEC as a broker-dealer and investment adviser. In addition, Goldman Sachs is a member of all major securities and futures exchanges worldwide and acts as dealer and market maker in a wide range of financial instruments. Among other things, Goldman Sachs is actively engaged in the execution and clearance of transactions in the full range of financial and commodity futures, options on such futures and other derivative products.

Need and Benefits of Foreign Security Index Contracts

As part of its FCM business, Goldman Sachs regularly executes and clears transactions in futures and options on futures on behalf of investment advisors, pension funds, endowments, large money managers and other institutional market participants. These entities have for many years used domestic and foreign futures markets to implement their trading strategies, both through transactions effected exclusively in the futures market and through hedging or other types of transactions involving futures and related transactions in other markets. Equity derivatives and, in particular, foreign security index contracts are routinely used by these institutions to make existing strategies more efficient and new strategies possible. These strategies include enhanced fund management, asset allocation (both among sectors and countries), view-driven strategies and risk management. It is well-recognized that sector and country-based products and, in particular, the use of stock index futures products can reduce risk and improve performance. Furthermore, stock index futures products provide flexibility, leverage and liquidity making them ideal vehicles for institutional investment.

Modern portfolio investment theory recognizes that these institutions can both reduce their risk and increase their performance with a diversified portfolio that includes investments in non-U.S. sectors and countries. As the SEC is aware, U.S. persons may, consistent with the federal securities laws, invest in and trade foreign securities. The potential, as addressed below, that certain foreign security index contracts may not be able to be purchased

* With respect to the Appendix A standard, Goldman Sachs would not object to imposing the same market capitalization requirement now included in Section 4(a) as part of the 75 percent test in Section 4(b).

or sold by these same institutions is of great concern and is unjustifiable. These institutions currently use both domestic and foreign security index contracts that are permitted to be offered and sold in the U.S. for a variety of trading strategies. Futures can be used to replicate equity indices, along with cash equivalent or market neutral strategies. Institutional investors run synthetic international equity index funds using non-U.S. index futures to track international benchmarks such as the MSCI™ EAFE. These same investors employ strategies using global futures to implement view-based asset allocation strategies or to better match global or international benchmarks, overlaying active international strategies.

These institutional investors are "eligible contract participants" ("ECPs") under Section 1a(12) of the CEA and, as such, most of them have the capacity to enter into principal-to-principal derivative transactions that replicate foreign security index contracts. However, OTC contracts involve different risks, including counterparty risks, and are more costly, less efficient and less liquid than foreign securities index contracts. It would be ironic for the CFMA to drive these institutions away from their preferred exchange-traded market toward the OTC market. The thrust of the CFMA was to provide legal certainty for both exchange-traded and OTC markets and to eliminate any regulatory biases between the two markets.

Criteria for Approval of Foreign Security Index Contracts

Futures contracts on broad-based stock indices are regulated exclusively by the CFTC. Futures on narrow-based stock indices will be regulated jointly by the SEC and the CFTC when they become legally permitted later this year. While the CFMA is silent on the criteria that a foreign security index contract must meet in order to qualify as broad-based (i.e., not narrow-based), the Proposed Rules provide that foreign security index contracts must comply with all of the criteria that domestic stock indices must satisfy in order to qualify as broad-based ("U.S. Statutory Criteria").

The U.S. Statutory Criteria were developed based on the size, diversity and liquidity of the U.S. equity markets. As a result, certain foreign stock indices may not satisfy the criteria, even though these indices would be deemed "broad-based" relative to the size and characteristics of their local stock markets. Some may fail to meet the broad-based test due to market concentration and liquidity conditions in the relevant market, which will unavoidably cause a few securities to account for more than 60% of the index's weight. As the Commissions' release regarding the Proposed Rules acknowledges, certain foreign security futures contracts that are currently offered in the United States, pursuant to no-action letters by the CFTC staff (with the concurrence of the SEC staff) will not meet the U.S. Statutory Criteria.* If a foreign security futures contract cannot qualify as broad-based, it is possible that it will not be permitted to trade in the United States at all, because it will not meet the SEC's requirements applicable to

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* By our analysis, at least four of the currently approved or applied for foreign security futures contracts fail this 60% test.

security futures contracts (which include narrow-based security index futures). If the SEC were to require that each component security of an index be registered under Section 12 of the Exchange Act and that the foreign board of trade on which the stock index is traded be registered as a national securities exchange, such conditions would virtually ensure that the contracts would not be available to U.S. persons. The adverse impact that such a result would have on a wide variety of institutions and a broad range of U.S. citizens (most notably pension holders and collective investment participants), cannot be consistent with the intent of the CFMA. Indeed, the relevant amendments that the CFMA imposed on the Commissions' governing statutes vest the Commissions with plenary authority to adopt a different standard for foreign security index contracts and instruct the Commissions to take into account, "as appropriate, the nature and size of the markets that the securities underlying the securities futures product reflects."* As a result, we endorse the additional test set forth in the FIA comment letter as one standard that will permit FCMs and their customers access to a wider range of foreign security index contracts that currently or in the future may be listed for trading, without any adverse effect on the public interest or the protection of investors. We recognize that this may not be the only alternative standard that can achieve this goal, and we would welcome the opportunity to work with the Commissions as they consider additional tests.

Congress established principles to guide the Commissions in adopting standards to permit domestic and foreign security index contracts. The rules must: 1) be necessary or appropriate in the public interest, 2) promote fair competition, 3) be consistent with the promotion of market efficiency, innovation and expansion of investment opportunities, 4) protect investors, and 5) maintain fair and orderly markets.** For the reasons set forth in the FIA comment letter, the proposed regulatory standard for foreign security index contracts set forth in Appendix A conforms to these Congressional principals. We will not repeat in this comment letter the analysis set forth by the FIA. However, it is important to point out that this new proposed regulatory standard in Appendix A is very close to the U.S. Statutory Criteria – the critical difference is that it takes into account the fact that foreign securities markets generally do not have the size and depth of the U.S. markets. By requiring that the foreign security index contract must represent, on average, at least 50 percent of the total market capitalization of the underlying securities exchange, market or relevant industry sector, this standard ensures that the index fairly reflects the underlying market sector, is not readily susceptible to manipulation, and cannot effectively be used as a surrogate for trading any individual component of the index. To deny institutions, including pension funds, investment companies, endowments and other large institutional investors that are already active participants in the international securities markets the opportunity to take advantage of these efficient, liquid products cannot be in the public interest.

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* Exchange Act §§ 3(a)(55)(C)(iv) and 6(k); CEA §§ 1a(25)(B)(iv) and 2(a)(1)(E).

** CFMA § 206(*l*).

In conclusion, we wish to make four additional points. First, Goldman Sachs respectfully requests that the Commissions use their exemptive authority to extend the 18-month grandfather provisions currently applicable to approved foreign security futures contracts indefinitely. These contracts have been trading for a number of years without incident. No regulatory or other purpose would be served by exposing these contracts to the legal uncertainty that the expiration of the existing grandfather provisions creates.

Second, Goldman Sachs respectfully requests that the Commissions provide a procedure for exemptive relief beyond the terms of the U.S. Statutory Criteria and the new regulatory standard in Appendix A, in addition to any other standards the Commissions may establish, to take into account new developments and changes in international markets. In particular, because of the significant benefits of foreign security index contracts, it is essential that the Commissions remain flexible in addressing and permitting new products that serve the public interest. The procedure for seeking, and the timing for approval of, exemptive relief should be set forth clearly. Uncertainty about the process and delays in approval adversely affect institutional market participants and U.S. citizens.

Further, in considering exemptive relief, the Commissions should include a procedure that permits ECPs to trade foreign security index contracts regardless of whether they are broad- or narrow-based. The CFMA recognizes that this class of investors does not need the same regulatory protections or oversight. They should be afforded the same rights to trade on regulated exchanges as the CFMA provides for their trading OTC.

Third, Goldman Sachs remains concerned that the criteria for measuring when an index no longer qualifies as broad-based is so limiting and the timing for either changing the index or ceasing to trade is so short that the consequences will be unnecessarily destabilizing to the markets. Of course, the addition of the new regulatory standard in Appendix A eases some of this pressure with respect to certain types of indices. However, there still remain significant risks for foreign security index contracts. As a result, we suggest a careful review of these criteria with a view toward allowing the indexes to go below the threshold for a longer period of time before requirements are triggered. In addition, we note that (1) indexes generally are designed by third parties who are not under the control of the exchange, making it very difficult for an exchange to effect modification of the index, and (2) to the extent that an index is designed to reflect a particular sector or country, modification may not be in the public interest because the index may no longer reflect the sector or country it was designed to reflect. Therefore, we suggest that the consequences of falling below the threshold should not be to require modification of the index or termination of trading. Instead, we suggest that the Commissions impose appropriate additional requirements on the foreign security index contract if it is not modified so that it can continue to trade and not disadvantage U.S. participants.

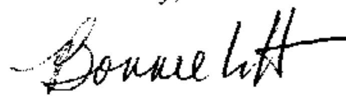
Finally, Goldman Sachs would like to address an issue raised in the Proposed Rules that does not relate specifically to foreign security index contracts. Specifically, the

Commissions have requested comment on the proposal for calculating the "average price" of a security. CEA Rule 41.11(b)(2)(i) and Exchange Act Rule 3a55-1. The proposed methods for determining market capitalization and dollar value of average daily trading volume require using a volume-weighted average price ("VWAP") calculated over a six-month period for each index constituent. In our view, the use of VWAP makes the calculation more complicated, reduces the ability of others to replicate or verify the figures, and does not increase the reliability of the results. Although a handful of pricing vendors provide VWAP by stock, exact methodology differs by vendor, resulting in different VWAPs. The use of official closing prices on the stock's primary market could be more easily verified than volume-weighted average prices. The use of a six-month average should minimize the impact of any deviations between the closing prices and the volume-weighted prices.

<u>Conclusion</u>

Goldman Sachs appreciates the opportunity to comment on the Proposed Rules. We stand ready to provide any further assistance that may be helpful to the Commissions in their consideration of these very important issues. In particular, we would be pleased to assist in any endeavor the Commissions undertook to design standards that will allow a wider range of foreign security index contracts to trade.

Sincerely,



Bonnie S. Litt

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(Enclosures)

Appendix A

Recommended Standards for Determining that a Foreign Security Index Contract is Broad-Based

An index traded on a foreign exchange will be a broad-based security index subject to the exclusive jurisdiction of the Commodity Futures Trading Commission, if the contract is cash-settled and:

1. The component securities of the index include at least 10 unaffiliated companies;[1]

2. All of the securities in the index are securities of companies organized outside the US, and securities comprising at least 75 percent of the weighted value of the index are primarily traded on non-US exchanges or markets; [2]

3. No component security (or aggregate of affiliated component securities) comprises more than 30 percent of the index's weighting; and

4. Either:

   (a) The market capitalization of the index—

   (i) averaged at least $40 billion during the preceding 12 calendar months; and

   (ii) on average, represents at least 50 percent of the total market capitalization of the underlying stock exchange, market or relevant sector; or

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1 The standard acknowledges that cross-ownership of publicly held companies is more prevalent outside of the US. Consequently, it is appropriate to consider the degree of cross-ownership that should be permitted before companies are found to be "affiliated" for purposes of this standard. FIA believes that, as a threshold, companies may be deemed to be unaffiliated if no more than 30 percent of each company is under common control or ownership. In addition, there may be circumstances when because of the unique characteristics of a foreign market, it is appropriate and consistent with the purposes of the CFMA to permit a greater degree of cross ownership. In any event, consistent with our earlier comments, we emphasize that the Commissions should grandfather permanently all currently approved foreign security index contracts. Further, in all circumstances, issuers that are affiliated solely on the basis of government ownership should not be considered affiliated for this purpose.

2 A security would be deemed to be traded primarily on foreign exchanges or markets if, on average over the preceding 12 months, 50 percent or more of the aggregate dollar volume was traded on foreign exchanges or markets.

(b) The five highest-weighted component securities (or aggregate of affiliated component securities) in the aggregate comprise no more than 75 percent of the index's weighting.