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May 16, 2006

Jean A. Webb, Secretary
Commodity Futures Trading Commission
1155 21st Street NW
Washington DC 20581

COMMENT

Nancy M. Morris, Secretary
Securities and Exhange Commission
450 Fifth Street NW
Washington DC 20549-0609

**Re: Joint Proposed Rules: Application of the Definition of Narrow-Based Security Index to Debt Securities Indexes and Security Futures on Debt Securities, 71 *Fed.Reg.* 18030, April 10, 2006**

Dear Ms. Webb and Ms. Morris:

The Futures Industry Association ("FIA")[1] is pleased to submit this letter in support of the above-referenced rules that the Commodity Futures Trading Commission ("CFTC") and the Securities and Exchange Commission ("SEC") (collectively, the "Commissions") have proposed, which would exclude from the definition of a "narrow-based security index" debt securities indexes that satisfy the criteria set forth in the proposed rules. As the Commissions' note in the accompanying *Federal Register* release, because the statutory definition of a narrow-based security index[2] "was designed primarily for indexes composed of equity securities, not debt securities, . . . most indexes comprised of debt securities regardless of the number or amount of the underlying component securities in

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[1] FIA is a principal spokesman for the commodity futures and options industry. Our regular membership is comprised of approximately 40 of the largest futures commission merchants ("FCMs") in the United States. Among our approximately 150 associate members are representatives of virtually all other segments of the futures industry, both national and international, including US and international exchanges, banks, legal and accounting firms, introducing brokers, commodity trading advisors, commodity pool operators and other market participants, and information and equipment providers. Reflecting the scope and diversity of our membership, FIA estimates that our members effect more than 90 percent of all customer transactions executed on US contract markets.

[2] Section 1a(25)(A)(i)-(iv) of the Commodity Exchange Act ("CEA") and section 3(a)(55)(B)(i)-(iv) of the Securities Exchange Act of 1934 ("Exchange Act").

the index, [would] fall within the definition of narrow-based security index."[3] We are pleased, therefore, that the Commissions have determined to use their authority under the CEA and the Exchange Act to exclude from the definition of narrow-based security index those debt security indexes that would meet the terms and conditions of the proposed rules.[4]

In promulgating final rules, we respectfully ask the Commissions to clarify two matters. First, we request the Commissions to confirm that a debt security index that meets the criteria in the proposed rules will be broad-based even if the index includes products or instruments that are not securities. (We understand that a debt security index will not be considered broad-based if it contains any equity security.) Second, we request the Commissions to confirm that, in the event a debt securities index includes exempt as well as non-exempt securities, only non-exempt securities must be taken into account in determining compliance with the criteria set out in the proposed rules.[5]

We also want to take this opportunity to encourage the Commissions to act promptly to propose for comment a regulatory standard governing the offer and sale of security index futures contracts traded on or subject to the rules of exchanges and boards of trade located outside of the United States ("foreign security index contracts"). We respectfully submit that, just as the statutory definition of narrow-based security index "was designed primarily for indexes composed of equity securities, not debt securities," the statutory definition was designed for indexes whose component securities are US equity securities, not non-US equity securities. Therefore, it is no less appropriate to grant foreign security index contracts relief from the statutory definition of narrow-based security index. To the contrary, as we have previously advised the Commissions, it is our position that the various amendments to the Exchange Act and the CEA effectively compel the Commissions to adopt a separate standard for foreign security index contracts.[6]

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[3] 71 *Fed.Reg.* 18030, 18031.

[4] Section 1a(25)(B)(vi) of the CEA and section 3(a)(55)(B)(vi) of the Exchange Act provide that a security index is not narrow-based if "a contract of sale for future delivery on the index is traded on or subject to the rules of a board of trade and meets such requirements as are jointly established by rule, regulation or order by the [Commissions]."

[5] FIA has also reviewed the comment letters filed by the Chicago Mercantile Exchange and the Chicago Board of Trade. We support their comments and ask the Commissions to give them every consideration.

[6] *See,* Letter to Jean A. Webb, Secretary, Commodity Futures Trading Commission, and Jonathan G. Katz, Secretary, Securities and Exchange Commission, from John M. Damgard, President, Futures Industry Association, dated July 18, 2001, commenting on the Commissions' proposed amendments establishing the method to be used in determining the "dollar value of average trading volume" and "market capitalization" for purposes of the definition of a "narrow-based security index.." A copy of this letter is enclosed for the convenience of the Commissions.

We thank the Commissions for their consideration of the views expressed in this letter and would welcome the opportunity to discuss them in greater detail with the members of the Commissions or their staffs. If you have any questions concerning the matters discussed herein, please contact Barbara Wierzynski, FIA's General Counsel, or me at (202) 466-5460.

Sincerely,

John M. Damgard
President

FUTURES INDUSTRY ASSOCIATION

INC.

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July 18, 2001 Revised

Ms. Jean A. Webb
Secretary to the Commission
Commodity Futures Trading Commission
1155 21ST Street NW
Washington DC 20581

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

**Re: Narrow-Based Security Indexes, 66 *Fed. Reg.* 27560 (May 17, 2001)**
**SEC File No. S7-11-01**

Dear Ms. Webb and Mr. Katz:

The Futures Industry Association ("FIA") welcomes this opportunity to comment on 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 Exchange Act ("CEA") and the Securities Exchange Act of 1934 ("Exchange Act") relating to security futures products.[1] Our comments are limited to the Commissions' proposal to apply 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 and whose component securities are non-US securities ("foreign security index contracts") the same definition of a narrow-based security index designed for US index futures contracts. In lieu of the statutory standard, FIA endorses a separate regulatory standard for foreign security index contracts.

FIA respectfully submits that the application of the statutory test alone would be contrary to the intent of Congress in enacting the Commodity Futures Modernization Act of 2000 ("CFMA"). The relevant amendments to 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 security futures product reflects."[2] These amendments reflect congressional determination that, consistent with the public interest and the protection of investors, a statutory test, clearly designed for the US securities markets, should not restrict or possibly deny US FCMs and their customers access to the wide range of foreign security index contracts that currently or in the future may be listed for trading.

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1 FIA is a principal spokesman for the commodity futures and options industry. Our regular membership is comprised of approximately 60 of the largest futures commission merchants ("FCMs") in the United States, the majority of which are also registered broker-dealers. Among our associate members are representatives from virtually all other segments of the futures industry, both national and international. Reflecting the scope and diversity of our membership, FIA estimates that our members effect more than 90 percent of all customer transactions executed on US contract markets.

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

Application of the statutory standard to foreign security index contracts could have this effect, seriously disrupting the ability of our members' customers to use foreign security index contracts to implement international securities trading strategies and precluding US FCMs from carrying foreign security index contracts on their behalf. FIA, therefore, encourages the Commissions to exercise the rulemaking authority that Congress granted specifically to address foreign security index contracts and adopt a regulatory standard defining a broad-based security index that takes into appropriate account "the nature and size of the markets that the securities underlying the security futures product reflects."[3]

FIA's recommended standard for determining when a foreign security index contract would be broad-based is set forth at Appendix A to this letter.[4] We are confident that the recommended standard is consistent with the guidelines that Congress established in Exchange Act §6(k) and CEA §2(a)(1)(E).[5] However, we realize that other standards may well be designed to achieve the same goals. In this regard, FIA would welcome the opportunity to meet with the Commissions' respective staffs to discuss the provisions of the standard in greater detail and to assist the staffs in analyzing any adjustments to the standard that they or other parties might suggest.

We also wish to emphasize that this standard was developed after evaluating only the foreign security index contracts that the CFTC has approved for trading to date, as well as those contracts for which applications for approval are pending. As investment strategies evolve, the risk management tools that support them, including security index contracts, also will evolve. These changes are likely to demand modifications to the standard used to review security index contracts. The Commissions, therefore, must be prepared to amend any standard that they may adopt in order to reflect the realities of markets over time.[6] Further, FIA encourages the Commissions to adopt procedures by which a foreign exchange (or affected market participants) may request the Commissions to find that, although a particular security index does not meet the regulatory standard, it may be treated as broad-based.

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[3] As noted, FIA's focus is on foreign security index contracts. With one exception, our comments do not address issues relating to transactions in security index products traded on or subject to the rules of US exchanges but whose component securities are non-US securities. (FIA comments below on the Commission's statutory authority to authorize a US exchange to list for trading a security index product whose component securities are non-US securities.) Similarly, we do not address transactions in security index products that are traded on or subject to the rules of non-US exchanges but whose component securities are US securities. As a matter of policy, FIA believes that the markets, not a particular regulatory regime, should determine the success or failure of any product. Nonetheless, we do not believe that it is necessary to address these permutations in order to adopt the standards for foreign security index contracts that FIA is recommending in this letter.

[4] FIA understands that certain FIA member firms previously have discussed a slightly different variation of this recommended standard with the Commissions' staffs.

[5] Fn. 20, infra, and accompanying text.

[6] FIA's position in this regard is not limited to foreign security index products. The Commissions should be prepared to exercise their general exemptive authority as necessary to amend the statutory standard with respect to US security index contracts. See discussion at page 8, infra.

The public interest requires that the Commissions move forward and grant the requested relief with respect to foreign security index contracts promptly.[7] As noted, unnecessary delay could disrupt or prohibit entirely the implementation of existing trading strategies by investors. Further, applications for approval of approximately 10 foreign stock index contracts are pending at the CFTC and their fate may well rest on the Commissions' definition of a broad-based index. For this same reason, other foreign exchanges no doubt are waiting for the Commissions to act before filing an application at all.[8]

**Application of the statutory definition of a narrow-based security index is inappropriate for foreign security index contracts.**

The distinction between a narrow-based security index and a broad-based security index, of course, determines the US regulatory structure that will govern trading in the security index product.[9] Narrow-based security index products are subject to the jurisdiction of both the SEC and the CFTC. Broad-based security index products, on the other hand, are subject only to the jurisdiction of the CFTC. While this distinction is important in determining where and pursuant to which set of rules a US customer will effect a security index product traded on a US exchange, it is vital in determining whether customers will be permitted to effect transactions in a foreign security index contract at all.

FIA member firms have undertaken a preliminary analysis of the foreign security index contracts that have been approved for trading by customers or with respect to which an application for approval has been filed with the CFTC. This analysis indicates that the provisions of the Exchange Act and the CEA relating to security futures products, *i.e.*, futures on individual securities and narrow-based indexes, could prohibit US FCMs and broker-dealers from carrying positions on behalf of their customers in many foreign security index contracts, including several contracts that are currently approved for trading in the US.

For example, because the five highest-weighted component securities in the aggregate comprise more than 60 percent of their respective weighting, certain foreign security index contracts that

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[7] In this regard, at the time the amendments relating to foreign security index contracts were forwarded to Congress for consideration, SEC staff confirmed to FIA representatives that the provisions of the amendments requiring the Commissions to adopt rules "[t]o the extent necessary or appropriate . . . to promote fair competition" (Exchange Act §6(k); CEA §2(a)(1)(E)) would require that such rules have an effective date that would be concurrent with the initiation of trading of security futures products on US exchanges.

[8] The potential breadth of the foreign security index market is substantial. FIA tracks trading data on approximately 80 foreign security index futures contracts traded on more than 20 international exchanges. (An almost equal number of security index option contracts are also listed for trading.) In the aggregate, more than 160 million futures contracts in these indexes were traded in 1999 and more than 187 million futures contracts in these indexes were traded in 2000. In 2001, more than 66 million such futures contracts were traded from January through April. Clearly, not all of these contracts would satisfy the broad-based standard FIA is recommending.

[9] Relevant portions of the statutory standard are set forth in Appendix B to this letter.

the CFTC has approved for trading meet the primary statutory standard of a narrow-based index.[10] Moreover, because the securities underlying these security index contracts generally are not registered under section 12 of the Exchange Act, they do not satisfy the secondary statutory standard that excludes certain security indexes from the narrow-based definition.[11] The Exchange Act, however, generally requires narrow-based security index products to be listed on a national securities exchange or registered securities association.[12] Consequently, in the absence of further regulatory relief, any number of foreign security index contracts could be deemed to be narrow-based, possibly prohibiting customers from trading in such products.[13]

The customers of US FCMs include pension plans, investment companies, endowments, hedge funds and other large money managers. These entities are free to engage in transactions in the international securities markets with few regulatory limitations. In connection with their securities transactions, these entities also trade in authorized foreign security index contracts for various purposes, including risk management and asset allocation. Among other purposes, these entities run index funds designed to track global benchmarks, such as the MSCI World, or international benchmarks, such as the MSCI EAFE. Such funds use non-US index futures to manage liquidity or to synthetically replicate the index through futures. Money managers also use global futures as part of the active management strategies to implement view-based asset allocations or to match better international benchmarks, overlaying active international strategies.

The above entities are eligible contract participants under section 1a(12) of the CEA and, as such, they may enter into principal-to-principal derivatives transactions that replicate foreign security index contracts with other eligible counterparties.[14] Transactions involving over the counter products, however, are more difficult, and substantially more expensive, to effect. In these circumstances, FIA submits that no regulatory purpose is served by limiting the ability of customers from trading foreign security index contracts.

FIA, therefore, respectfully urges the Commissions to adopt the recommended standard set forth in Appendix A, by which foreign security index contracts will be determined to be broad-based or narrow-based. This standard will permit customers to trade a greater number of foreign security index contracts, while assuring that the Commissions' regulatory interests over security futures

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10 Exchange Act §3(a)(55)(B)(iii); CEA §1a(25)(A)(iii).

11 Exchange Act §3(a)(55)(C)(i)(III)(aa); CEA §1a(25)(B)(i)(III)(aa).

12 Exchange Act §6(h)(1). See also, CEA §2(a)(1)(D)(i)(I).

13 Four foreign security index contracts currently approved for trading or for which an application for approval is pending would not meet the statutory test for broad-based security index products: Hang Seng (Hong Kong); IBEX 35 (Spain); SMI (Switzerland); and MSCI Singapore Free (Singapore). Each of these index products has been trading for years without incident. For example, the Hang Seng futures contract has been trading since 1986. Statistics that FIA maintains indicate that the Hang Seng, the IBEX 35 and the SMI futures index contracts each had volume in excess of 5 million contracts in 1999, 4 million contracts in 2000 and 1.4 million contracts from January through April 2001. The MSCI Singapore contract is smaller, with volume of several hundred thousand contracts annually.

14 CEA §§1a(13), 2(d) and 2(e).

products offered to such customers are protected.[15] As discussed below, because foreign securities markets generally lack the size or depth of the US markets, the standard modifies the statutory concentration test and imposes a separate coverage test. The standard thus assures that the index fairly reflects the securities that comprise the underlying market or sector and is appropriate in light of "the nature and size of the markets that the securities underlying the security futures product reflects."

**The relevant provisions of the Exchange Act and the CEA support the adoption of a regulatory standard for foreign security index contracts.**

The Commissions have ample statutory authority to adopt a regulatory standard for foreign security index contracts. Indeed, FIA submits that the provisions of these statutes effectively compel the Commissions to pursue this course of action.

When the Commissions first proposed amendments to the CEA and the various securities laws to remove the prohibition on futures on individual securities and narrow-based security indexes, the recommendations focused almost exclusively on US securities traded on US markets. The foreign markets were, at best, an afterthought. The standards defining narrow-based security indexes, in particular, were designed with the US securities markets in mind. Few, if any, foreign markets have the size and depth that compares to the US markets. Consequently, although the statutory standards established a meaningful and acceptable division between broad-based index contracts that are the exclusive jurisdiction of the CFTC and narrow-based index products for which jurisdiction is shared with the SEC in recognition of that agency's statutory interest in assuring the integrity of the underlying securities markets, the standards are of little value in evaluating foreign security index contracts.

As FIA and other industry representatives analyzed the Commissions' recommendations, it soon became clear that they would affect adversely the ability of customers to trade foreign security index contracts.[16] After an eighteen-month grandfather period, customers could be prohibited from trading certain index products currently approved.[17] The fate of pending applications and other index products for which applications have not been filed was even more uncertain.

Moreover, the ability of US FCMs to carry other index products on behalf of non-US customers could be restricted. This latter outcome, which appears to have been nothing more than an unintended consequence of the Commissions' focused attention on the US markets and US security indexes, achieves no regulatory purpose. To the contrary, it contradicts a longstanding position to which both Commissions' had agreed and could adversely affect ongoing business

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15 FIA expects that the overwhelming majority of transactions in foreign security index contracts would be effected on behalf of eligible contract participants. Nonetheless, FIA is not suggesting at this time that foreign security index contracts that satisfy the recommended standard, but not the statutory test, should be available only to customers that are eligible contract participants.

16 Fn. 10-13, supra, and accompanying text.

17 Fn. 13, supra.

activities of a number of US FCMs.[18] In sum, rather than expanding the range of foreign security index contracts that would be available to US investors, the Commissions' recommendations would result in an inadvertent, yet significant, contraction.

FIA, therefore, initiated discussions on these issues with the Commissions' respective staffs, members of Congress and their staffs, and representatives of the Department of the Treasury, as well as other affected industry representatives. At the conclusion of these discussions, all parties, including the Commissions staffs, agreed to recommend that Congress further revise the Commissions' proposal to assure that customers would continue to have the ability to trade foreign security products.

Congress accepted these recommendations. As enacted, therefore, the amendments to the Exchange Act and CEA grant the Commissions complete authority to adopt separate standards for classifying foreign security index contracts as narrow-based.[19] Further, Congress signaled its intent that the Commissions exercise this authority by instructing the Commissions to adopt "such rules, regulations or orders as are necessary or appropriate to permit the offer and sale of security futures products traded on or subject to the rules of a foreign board of trade." The legislation further directs the Commissions to "take into account, as appropriate, the nature and size of the markets that the securities underlying the security futures product reflects."[20]

Congress also established principles to guide the Commissions in adopting such rules. The rules must be necessary or appropriate (1) in the public interest, (2) to promote fair competition, (3) consistent with the promotion of market efficiency, innovation, and expansion of investment opportunities, (4) the protection of investors, and (5) the maintenance of fair and orderly markets.[21] For the reasons described below, FIA submits that the standard it has recommended conforms to these congressional principles.

Before turning to a brief discussion of these guidelines, we wish to emphasize that the recommended standard does not differ significantly from the statutory standard for broad-based indexes. For example, the recommended standard requires that the index must be comprised of

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[18] In 1992, the CFTC, with the consent of the SEC, authorized US FCMs to carry on behalf of non-US customers, foreign security index contracts that had not been approved for trading by US persons. 57 *Fed. Reg. 36369*, August 13, 1992. As with other aspects of the Commissions' approach to foreign security index contracts, FCMs have engaged in this activity without incident on behalf of their non-US customers without incident. In addition to the further revisions to the Exchange Act and CEA discussed below, therefore, Congress accepted the recommendations of the Commissions and industry representatives and adopted an amendment that confirmed the right of FCMs to continue to carry such products on behalf of non-customers. CEA §2(a)(1)(F)(i).

[19] Exchange Act §3(a)(55)(C)(iv) and CEA §1a(25)(B)(iv) provide that an index is not a narrow-based index, if "a contract of sale for future delivery on the index is traded on or subject to the rules of a foreign board of trade and meets such requirements" as the Commissions jointly establish by rule or regulation.

[20] Exchange Act §6(k); CEA §2(a)(1)(E). These provisions confirm the Commissions' general authority in Exchange Act §3(a)(55)(C)(iv) and CEA §1a(25)(B)(iv) and provide guidance in the exercise of that authority.

[21] Id.

securities representing at least 10 unaffiliated companies. In addition, no component security (or aggregate of affiliated component securities) may comprise more than 30 percent of the index's weighting. However, because foreign securities markets generally do not have the size and depth of the US markets,[22] we have modified the concentration test[23] and have added a coverage test. Under the recommended standard, the securities that comprise the index must represent, on average, at least 50 percent of the total market capitalization of the underlying stock exchange, market or relevant industry sector. This latter provision assures that the index fairly reflects the securities that comprise the underlying market or sector and is appropriate, in light of "the nature and size of the markets that the securities underlying the security futures product reflects."

**The Recommended Standard Is in Public Interest.** As discussed above, US pension funds, investment companies, endowments, hedge funds and other large institutional investors are active participants in the international securities markets. The public interest is served when these investors have the ability to hedge or otherwise mange the risks associated with these securities through the purchase or sale of futures on relevant security index. As noted earlier, transactions on exchanges are less difficult and less costly to effect than over the counter derivatives transactions, into which the vast majority of affected US investors are authorized to enter.

The public interest is served as well when the legal status of security index contracts is clear. As the Commissions are aware, a primary purpose of the CFMA was to bring legal certainty to derivatives products traded over the counter. Legal certainty is no less important to participants in exchange-traded products. It would be ironic if the Commissions, by failing to exercise the exemptive authority Congress specifically vested in them, unnecessarily created legal uncertainty with respect to foreign security index contracts.[24]

**The Recommended Standard Promotes Fair Competition.** The recommended standard promotes fair competition by assuring that foreign exchanges will have the ability to offer customers that trade in international markets the same types of risk management tools that US investors trading on US securities markets will have. Moreover, the recommended standard will permit foreign exchanges to compete more fairly with US and foreign financial institutions that are able to offer US eligible contract participants comparable products on a principal to principal basis without regulatory constraint.

The Commissions have asked how they should address any potential competitive disadvantage that US markets might face if foreign security products are subject to a regulatory standard. Presumably, the Commissions are concerned that US markets would be prohibited from treating

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[22] Nonetheless, the recommended standard requires that the market capitalization of the index must average at least $40 million during the preceding 12 months.

[23] Exchange Act §3(a)(55)(B)(iii); CEA §1a(25)(A)(iii).

[24] The public interest is also served by removing or at least limiting regulatory impediments to the development of global markets and encouraging international cooperation among regulatory authorities generally. As indicated above, the potential breadth of the foreign security index market is substantial. See fn. 8. To the extent practicable and consistent with the provisions of their governing statutes, the Commissions should facilitate access to these markets by US FCMs and broker-dealers and their customers.

as broad-based any security index that does not satisfy the statutory test. FIA respectfully disagrees. We note that the SEC has general exemptive authority under section 36 of the Exchange Act to "exempt any person, security or transaction, or any class or classes of persons, securities or transactions, from any provision or provisions" of that Act. Similarly, under section 4(c) of the CEA, the CFTC and the SEC may jointly exempt any agreement, contract or transaction from the provisions of section 2(a)(1)(D). Therefore, the Commissions have sufficient statutory authority to permit US exchanges to treat as broad-based those foreign security index contracts that conform to the recommended regulatory standard.

On this latter point, we believe that the Commissions should not be reluctant to use their exemptive authority to grant appropriate relief with respect to any aspect of the provisions of the relevant statutes. The regulatory structure governing futures contracts on individual equities and narrow-based indexes set forth in the CFMA obviously reflected the best judgment of the Commissions at the time the law was enacted. In contrast to previous amendments to the Exchange Act and CEA, however, these provisions enacted through the CFMA were not designed to address actual problems in an existing market. Rather, they were designed to address potential problems that the Commissions anticipated could arise. As these markets develop, however, the Commissions may well find that different approaches are necessary. The amendment to section 4(c) of the CEA, in particular, reflects Congress' decision to vest the Commissions with the authority to grant exemptions as appropriate to permit these markets to flourish.[25]

**The Recommended Standard Promotes Market Efficiency,** Innovation and Expansion of Investment Opportunities. As discussed above, the recommended standards will promote market efficiency and investment opportunities by affording US investors the opportunity to use the risk management tools essential to participating in the international securities markets.

**The Recommended Standard Protects Investors.** The recommended standard will continue to assure protection of customers that trade in foreign security index contracts. In particular, the standard is designed to assure that it cannot be used to manipulate the market for the underlying securities that comprise the index or as a surrogate for trading any individual component of the index. Moreover, the recommended standard assures that the index will fairly represent the securities that comprise the underlying market.

**The Recommended Standard Maintains Fair and Orderly Markets.** The recommended standards will help to maintain fair and orderly markets by allowing customers of US FCMs access to appropriate risk management tools for their international securities activities. Moreover, as noted, an index that satisfies the recommended standard cannot be used to manipulate the market for the underlying securities that comprise the index or as a surrogate for trading any individual component of the index. In addition, the recommended standard will reduce the possibility that certain indexes will "flip" between being broad-based and narrow-based. Because the statutory test was not designed for foreign markets, the risk of frequent flipping is greater.

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[25] In this regard, FIA encourages the Commissions to use their exemptive authority to extend the 18-month grandfather provisions for an indefinite period. Exchange Act §3(a)(55)(C)(v); CEA §1a(25)(B)(v). As noted earlier, each of these contracts has been trading for a number of years without incident. No regulatory purpose would be served by exposing these contracts to the legal uncertainty that the existing grandfather provisions create.

The result would be increased legal uncertainty, which would be disruptive to the markets for these products generally and could adversely affect customers trading in them.

The Commissions also should recognize that foreign exchanges, like their US counterparts, generally would not have an opportunity to adjust the composition of an index simply to satisfy the US test. First, indexes are developed by independent third parties, and the exchange on which it is traded does not have the authority to require any changes. Second, the indexes are designed to reflect the market of a particular country or sector of the economy. Changes solely for the purpose of meeting the statutory test could result in a skewed index, whose value to investors would then be reduced. Therefore, in lieu of requiring an exchange to modify the composition of the index or prohibiting US FCMs and their customers from trading such security index contracts, the Commissions may wish to consider whether additional regulatory requirements would be more appropriate. Limited restrictions, rather than a complete prohibition, would be less disruptive to the market generally and US participants in particular.

For the all of the above reasons, FIA respectfully requests the Commissions to adopt the regulatory standard recommended in Appendix A to this letter for distinguishing between broad-based foreign security index contracts and narrow-based foreign security index contracts.

**Conclusion**

FIA appreciates the opportunity to submit these comments on the Commissions' proposed definition of narrow-based security indexes. If you have any questions regarding this letter, please contact Barbara Wierzynski, FIA's General Counsel, or me at (202) 466-5460.

Sincerely,

John M. Damgard
President

cc: Commodity Futures Trading Commission

Honorable James E. Newsome, Acting Chairman
Honorable Barbara Pedersen Holum
Honorable David D. Spears
Honorable Thomas J. Erickson

Securities and Exchange Commission

Honorable Laura S. Unger, Acting Chairman
Honorable Isaac C. Hunt, Jr.

## 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

   (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.

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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.

## Appendix B

### Statutory Test for Determining that a US Security Index Contract is Narrow-Based

As set forth in section 3(a)(55)(B) of the Exchange Act and section 1a(25)(A) of the CEA, a security index *is* narrow-based if:

(i) it has nine or fewer component securities;

(ii) in which a component security comprises more than 30 percent of the index's weighting;

(iii) in which the five highest-weighted component securities in the aggregate comprise more than 60 percent of the index's weighting; or

(iv) in which the lowest-weighted 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)

A security index *is not* narrow-based and, therefore, will be deemed to be broad-based, if, among other conditions:

(i) it has at least nine component securities;

(ii) no component security comprises more than 30 percent of the index's weighting; and

(iii) each component security is—

(a) registered pursuant to section 12 of the [Exchange Act];
(b) 1 of 750 securities with the largest market capitalization;
(c) 1 of 675 securities with the largest dollar value of the average daily trading value.[1]

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[1] Exchange Act §3(a)(55)(C); CEA §1a(25)(B).