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## Part IV

### Commodity Futures Trading Commission

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17 CFR Part 41

### Securities and Exchange Commission

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17 CFR Part 240

**Method for Determining Market  
Capitalization and Dollar Value of  
Average Daily Trading Volume;  
Application of the Definition of Narrow-  
Based Security Index; Proposed Rules**

## COMMODITY FUTURES TRADING COMMISSION

### 17 CFR Part 41

RIN 3038-AB77

## SECURITIES AND EXCHANGE COMMISSION

### 17 CFR Part 240

[Release No. 34-44288; File No. S7-11-01]

RIN 3235-A113

### Method for Determining Market Capitalization and Dollar Value of Average Daily Trading Volume; Application of the Definition of Narrow-Based Security Index

**AGENCIES:** Commodity Futures Trading Commission and Securities and Exchange Commission.

**ACTION:** Joint proposed rules.

**SUMMARY:** The Commodity Futures Trading Commission ("CFTC") and the Securities and Exchange Commission ("SEC") (collectively, "Commissions") are proposing Rule 41 under the Commodity Exchange Act ("CEA") and Rules 3a55-1 through 3a55-3 under the Securities Exchange Act of 1934 ("Exchange Act"). These proposed rules would implement new statutory provisions enacted by the Commodity Futures Modernization Act of 2000 ("CFMA"). Specifically, the CFMA directs the Commissions to jointly specify by rule or regulation the method to be used to determine "dollar value of average daily trading volume" and "market capitalization" for purposes of the new definition of "narrow-based security index" in the CEA and the Exchange Act. Proposed Rule 41.11 under the CEA and proposed Rule 3a55-1 under the Exchange Act are intended to fulfill this statutory directive by specifying such methods. In addition, these proposed rules define certain terms that would add clarity to the statutory definition of "narrow-based security index."

In addition, proposed Rule 41.12 under the CEA and proposed Rule 3a55-2 under the Exchange Act would create an exception to the definition of narrow-based security index, to permit, subject to certain conditions, a designated contract market, registered derivatives transaction execution facility ("DTEF"), or foreign board of trade to continue trading a contract of sale for future delivery on a security index that becomes a narrow-based security index during the first 30 days after the future begins trading. Similarly, proposed Rule 41.14 under

the CEA would permit a national securities exchange to continue trading a contract of sale for future delivery on an index that ceases to be a narrow-based security index, subject to certain conditions. These rules are intended to minimize market disruption when a broad-based security index becomes a narrow-based security index, and when a narrow-based security index becomes a broad-based security index.

Finally, proposed Rule 41.13 under the CEA and proposed Rule 3a55-3 under the Exchange Act would provide that when a futures contract on a security index is traded on or subject to the rules of a foreign board of trade, that index shall not be considered a narrow-based security index if it would not be a narrow-based security index pursuant to the statutory definition of a narrow-based security index or the exclusions from that definition. These rules would clarify and establish that when a futures contract on a security index is traded on or subject to the rules of a foreign board of trade, the index underlying such contract shall be considered a broad-based security index if it qualifies as such pursuant to the statutory definition of narrow-based security index, or pursuant to the exclusions from that definition.

**DATES:** Comments must be received on or before June 18, 2001.

**ADDRESSES:** Comments should be sent to both agencies at the addresses listed below.

CFTC: Comments should be sent to the Commodity Futures Trading Commission, Three Lafayette Centre, 1155 21st Street, NW., Washington, DC 20581, Attention: Office of the Secretariat. Comments may be sent by facsimile transmission to (202) 418-5521, or by e-mail to [secretary@cftc.gov](mailto:secretary@cftc.gov). Reference should be made to "Narrow-Based Security Indexes."

SEC: Persons wishing to submit written comments should send three copies to Jonathan G. Katz, Secretary, Securities and Exchange Commission, 450 Fifth Street, NW., Washington, DC 20549-0609. Comments also may be submitted electronically at the following e-mail address: [rule-comments@sec.gov](mailto:rule-comments@sec.gov). All comment letters should refer to File No. S7-11-01; this file number should be included on the subject line if e-mail is used. Comment letters received will be available for public inspection and copying in the SEC's Public Reference Room, 450 Fifth Street, NW., Washington, DC 20549-0102. Electronically submitted comment letters will be posted on the SEC's Internet web site (<http://www.sec.gov>). The SEC does not edit personal

identifying information, such as names or e-mail addresses, from electronic submissions. Submit only the information you wish to make publicly available.

#### FOR FURTHER INFORMATION CONTACT:

CFTC: Elizabeth L.R. Fox, Acting Deputy General Counsel; Richard A. Shilts, Acting Director; or Thomas M. Leahy, Jr., Financial Instruments Unit Chief, Division of Economic Analysis, Commodity Futures Trading Commission, Three Lafayette Centre, 1155 21st Street, NW., Washington, DC 20581. Telephone: (202) 418-5000. E-mail: ([EFox@cftc.gov](mailto:EFox@cftc.gov)), ([RShilts@cftc.gov](mailto:RShilts@cftc.gov)), or ([TLeahy@cftc.gov](mailto:TLeahy@cftc.gov)).

SEC: Nancy J. Sanow, Assistant Director, at (202) 942-0771; Ira L. Brandriss, Special Counsel, at (202) 942-0148; or Sapna C. Patel, Attorney, at (202) 942-0166, Office of Market Supervision, Division of Market Regulation, Securities and Exchange Commission, 450 Fifth Street, NW., Washington, DC 20549-1001.

**SUPPLEMENTARY INFORMATION:** The Commissions are proposing Subparts A and B of Rule 41 (Rules 41.1 and 41.2 and Rules 41.10 through 41.14) under the CEA,<sup>1</sup> 17 CFR 41, and Rules 3a55-1 through 3a55-3 under the Exchange Act,<sup>2</sup> 17 CFR 3a55-1 through 3a55-3.<sup>3</sup>

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<sup>1</sup> All references to the CEA are to 7 U.S.C. 1 *et seq.*

<sup>2</sup> All references to the Exchange Act are to 15 U.S.C. 78a *et seq.*

<sup>3</sup> Subpart A of proposed Rule 41 under the CEA consists of general provisions for purposes of the rule, including definitions (Rule 41.1) and recordkeeping requirements (Rule 41.2). Subpart B of proposed Rule 41, "Narrow-Based Security Indexes," begins with proposed Rule 41.10 on purpose and scope. Proposed Rules 41.11, 41.12, and 41.13 of Subpart B correspond to proposed Rules 3a55-1, 3a55-2, and 3a55-3 under the Exchange Act, respectively. Proposed Rule 41.14 of Subpart B parallels provisions incorporated in the CEA and the Exchange Act by the CFMA.

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## I. Introduction

The CFMA,<sup>4</sup> which became law on December 21, 2000, lifted the ban on single stock and narrow-based stock index futures ("security futures"). In addition, the CFMA established a framework for the joint regulation of these newly-permissible products by the CFTC and the SEC.

Prior to enactment of the CFMA, the Shad-Johnson Accord ("Accord") governed trading in contracts of sale for future delivery ("futures contracts" or "futures") on securities and security

indexes. Negotiated by the Chairmen of the SEC and the CFTC in 1982 and signed into law in 1983, the Accord permitted futures exchanges to offer futures contracts on security indexes if the contracts satisfied certain statutory criteria: (1) the contract had to be cash-settled; (2) the contract could not be readily susceptible to manipulation; and (3) the underlying securities had to measure and reflect the entire market or a substantial segment of the market, *i.e.*, it was a contract on a "broad-based" security index.<sup>5</sup> The Accord prohibited any futures contracts on security indexes that did not meet these criteria.

In addition to repealing the prohibition on certain types of security futures, the CFMA amended the CEA and the Exchange Act by adding a definition of "narrow-based security index." This definition establishes an objective test of whether a security index is narrow-based.<sup>6</sup> Futures contracts on security indexes that are narrow-based security indexes will be jointly regulated by the CFTC and the SEC under the framework established by the CFMA.<sup>7</sup> Futures contracts on indexes that are broad-based security indexes,<sup>8</sup> on the other hand, are under the sole jurisdiction of the CFTC and, therefore, only designated contract markets, registered derivatives transaction execution facilities ("DTEFs"), and foreign boards of trade may trade these products.

For this reason, it is important that the definition of "narrow-based security index" in the CEA and the Exchange Act be easily understood and applied by market participants. As directed by the CFMA, the rules jointly proposed today by the Commissions specify the method to be used to determine market capitalization and dollar value of average daily trading volume for purposes of the new definition of "narrow-based security index."<sup>9</sup>

<sup>5</sup> Section 2(a)(1)(B) of the CEA implemented the terms of the 1982 jurisdictional accord between the SEC and the CFTC, Futures Trading Act of 1982 Section 101, Publ. Law. No. 97-444, 96 Stat 2294 [codified at 7 U.S.C. Section 2(a)], *repealed* by the Commodity Futures Modernization Act of 2000, Pub. L. No. 106-554, 114 Stat. 2763 (2000).

<sup>6</sup> See Section 1a(25) of the CEA and Section 3(a)(55) of the Exchange Act.

<sup>7</sup> No person may execute or trade a security future product until the later of December 21, 2001 or such date that a futures association registered under Section 17 of the CEA meets the requirements in Section 15A(k)(2) of the Exchange Act, except that beginning on August 21, 2001, eligible contract participants may enter into transactions with each other on a principal-to-principal basis.

<sup>8</sup> Use of the term "broad-based security index" in this release means a security index that is not a narrow-based security index.

<sup>9</sup> Section 1a(25)(E) of the CEA and Section 3(a)(55)(F) of the Exchange Act.

The proposed rules would also establish provisions governing certain circumstances when narrow-based security indexes become broad-based, and when broad-based security indexes become narrow-based.

## II. Definition of "Narrow-Based Security Index"

The CFMA amended the definition of "security" in the Exchange Act,<sup>10</sup> the Securities Act of 1933 ("Securities Act"),<sup>11</sup> the Investment Company Act of 1940 ("Investment Company Act"),<sup>12</sup> and the Investment Advisers Act of 1940 ("Investment Advisers Act")<sup>13</sup> to include a "security future." For purposes of each of those Acts, as well as the CEA, "security future" is defined, in relevant part, as "a contract of sale for future delivery of a single security or of a *narrow-based security index*."<sup>14</sup> The definition of "narrow-based security index" in the CEA and the Exchange Act is the focus of this release.<sup>15</sup>

### A. Indexes Included within the Definition of a Narrow-Based Security Index

Under the CEA and the Exchange Act, an index is a "narrow-based security index" if it has *any one* of the following four characteristics: (1) it has nine or fewer component securities; (2) any one of its component securities comprises more than 30% of its weighting; (3) any group of five of its component securities together comprise more than 60% of its weighting; or (4) the lowest weighted component securities comprising, in the aggregate, 25% of the index's weighting have an aggregate dollar value of average daily trading volume ("ADTV") of less than \$50 million (or in the case of an index with 15 or more component

<sup>10</sup> Section 3(a)(10) of the Exchange Act.

<sup>11</sup> Section 2(a)(14) of the Securities Act, 15 U.S.C. 77b(a)(14).

<sup>12</sup> Section 2(a)(36) of the Investment Company Act, 15 U.S.C. 80a-2(a)(36).

<sup>13</sup> Section 202(a)(18) of the Investment Advisers Act, 15 U.S.C. 80b-2(a)(18).

<sup>14</sup> The term "security future" is defined in Section 3(a)(55)(A) of the Exchange Act. This definition is incorporated by reference in Section 2(a)(16) of the Securities Act, 15 U.S.C. 77b(a)(16); Section 2(a)(52) of the Investment Company Act, 15 U.S.C. 80a-2(a)(52); and Section 202(a)(27) of the Investment Advisers Act, 15 U.S.C. 80b-2(a)(27). "Security future" is also defined in Section 1a(31) of the CEA.

<sup>15</sup> See Section 3(a)(55) of the Exchange Act. The definition of "narrow-based security index" in the Exchange Act is incorporated by reference in Section 2(a)(16) of the Securities Act, 15 U.S.C. 77b(a)(16); Section 2(a)(52) of the Investment Company Act, 15 U.S.C. 80a-2(a)(52); and Section 202(a)(27) of the Investment Advisers Act, 15 U.S.C. 80b-2(a)(27). "Narrow-based security index" is also defined in Section 1a(25) of the CEA.

<sup>4</sup> Pub. L. No. 106-554, 114 Stat. 2763 (2000).

securities, \$30 million).<sup>16</sup> An index that has none of the four characteristics set forth above is not a “narrow-based security index.” Accordingly, any contract of sale for future delivery on such an index would not be a security future and thus would be subject to the sole jurisdiction of the CFTC.<sup>17</sup>

With regard to the fourth test noted above, *i.e.*, whether an index is a “narrow-based security index” based on the dollar value of ADTV of the lowest weighted securities in the index, the CEA and the Exchange Act require the CFTC and SEC to jointly specify the method of determining the dollar value of average daily trading volume, and mandate that this value be calculated as of the “preceding 6 full calendar months.”<sup>18</sup> The proposed rules discussed below in Part III. of this release specify such a method and define the terms “preceding 6 full calendar months” and “lowest weighted 25% of the index’s weighting” as those terms are used in the proposed rules.

#### *B. Indexes Excluded from the Definition of a Narrow-Based Security Index*

In addition to defining an index as narrow-based if the index has any of the characteristics described above, the definition of “narrow-based security index” in the CEA and Exchange Act *excludes* from its scope indexes that satisfy certain criteria. Any contract of sale for future delivery on an index excluded from the definition, as described below, is not a security futures product under the securities laws, and thus would be subject solely to the jurisdiction of the CFTC.

##### 1. The Index’s Component Securities Have High Market Capitalization and Dollar Value of Average Daily Trading Volume

Under the CEA and the Exchange Act, an index is not a “narrow-based security index” if it has *all* of the following characteristics: (1) it has at least nine component securities; (2) no component security comprises more than 30% of its weighting; (3) each of its component securities is registered under Section 12 of the Exchange Act; and (4) each component security is one of 750 securities with the largest market capitalization (“Top 750”) and one of

675 securities with the largest dollar value of ADTV (“Top 675”).<sup>19</sup>

The CEA and the Exchange Act require the Commissions to jointly specify the method to be used to determine market capitalization and dollar value of ADTV for purposes of this exclusion from the definition of “narrow-based security index.”<sup>20</sup> These values are to be calculated as of the preceding 6 full calendar months.<sup>21</sup> The rules the Commissions are proposing today specify the methods to determine these values, and are discussed below in Part III.

To assure that a futures contract on a security index qualifies for this exclusion, a designated contract market, registered DTEF, or foreign board of trade trading the futures contract must calculate both the Top 750 and Top 675 securities based on market capitalization and dollar value of ADTV, respectively, for the preceding 6 full calendar months, in addition to assessing compliance with the exclusion’s other criteria.<sup>22</sup>

**Q1:** The Commissions request comment on whether it would be difficult for market participants to determine the Top 750 and Top 675 out of all securities registered under Section 12 of the Exchange Act. Should the Commissions establish, by rule, a subset of Section 12-registered securities from which market participants would have to determine the Top 750 and Top 675? If so, what should this subset of securities be? For example, would it be appropriate to limit the universe of securities from which market participants determine the Top 750 and Top 675 to the securities traded on the New York Stock Exchange, the Nasdaq National Market System, and the American Stock Exchange? Is there another subset that would be more appropriate, such as the securities comprising the Russell 3000 Index?

<sup>19</sup> Section 1a(25)(B)(i) of the CEA and Section 3(a)(55)(C)(i) of the Exchange Act.

<sup>20</sup> Section 1a(25)(E) of the CEA and Section 3(a)(55)(F) of the Exchange Act.

<sup>21</sup> *Id.*

<sup>22</sup> As a general matter, any national securities exchange, designated contract market, registered DTEF, or foreign board of trade that trades a futures contract on a security index will be required to determine whether or not the contract is a security future to assure that the market is in compliance with the CEA and the Exchange Act. The Commissions note that national securities exchanges, designated contract markets, or registered DTEFs that trade security index futures will need to preserve records of all their determinations with respect to the daily narrow-based or non-narrow-based status of security indexes in order to comply with their recordkeeping requirements under Sections 5(d)(17) and 5a(d)(8) of the CEA and proposed Rule 41.2 under the CEA, and Rule 17a–1 under the Exchange Act, 17 CFR 240.17a–1.

**Q2:** The Commissions also request comment on whether they should undertake to determine the Top 750 and Top 675. For example, should the Commissions determine these securities and make these lists publicly available? If the Commissions do this, how often should the Top 750 and Top 675 be determined and published? Monthly? Quarterly? More or less often? If the Commissions do publish such lists, they would have to establish a rule that any security that appears on both the Top 750 and Top 675 list would be deemed to be one of the Top 750 and Top 675 securities every day during the period in which these lists were publicly available. Conversely, any security that did not appear on the lists would be deemed not to satisfy paragraph (B)(i)(III) of Section 1a(25) of the CEA and paragraph (C)(i)(III) of Section 3(a)(55) of the Exchange Act. The Commissions solicit commenters’ views on the benefits and drawbacks of this approach and on any preferable methods for the Commissions to determine the Top 750 and the Top 675.

**Q3:** Are there any other approaches or issues that the Commissions should consider with respect to determining the Top 750 and Top 675?

##### 2. A Futures Contract on a Broad-Based Security Index that Becomes Narrow-Based

###### a. Statutory Grace Period

If a futures contract were trading on an index that was broad-based for at least 30 days and subsequently the index became a narrow-based security index, the index is excluded from the definition of a “narrow-based security index” if it is narrow-based for 45 or fewer business days over the course of three consecutive calendar months. If the index is a “narrow-based security index” for *more than 45* business days over three consecutive calendar months, the index is a “narrow-based security index,” but the Exchange Act and the CEA provide a temporary grace period of three months before the futures contract becomes a security future.<sup>23</sup> In contrast, under these statutory provisions, if the futures contract has been trading for *fewer than 30* days as a contract of sale for future delivery on an index that is not a “narrow-based security index,” the future would become a security futures product immediately if the index satisfies any of the criteria set forth in Section 1a(25)(A) of the CEA and Section 3(a)(55)(B) of the Exchange Act.<sup>24</sup>

<sup>23</sup> Section 1a(25)(D) of the CEA and Section 3(a)(55)(E) of the Exchange Act.

<sup>24</sup> See *supra* note 16 and accompanying text.

<sup>16</sup> Section 1a(25)(A)(i)–(iv) of the CEA and Section 3(a)(55)(B)(i)–(iv) of the Exchange Act.

<sup>17</sup> See Section 2(a)(1)(C)(ii) of the CEA. A contract of sale for future delivery on a security index that is not a narrow-based security index may include component securities that are not registered under Section 12 of the Exchange Act.

<sup>18</sup> Section 1a(25)(E) of the CEA and Section 3(a)(55)(F) of the Exchange Act.

If a security index on which a futures contract is trading became narrow-based for more than 45 days over three consecutive months, and thus pursuant to Section 1a(25)(D) of the CEA and Section 3(a)(55)(E) of the Exchange Act becomes narrow-based, the Commissions believe that in order for trading to continue to be regulated exclusively by the CFTC, the designated contract market, registered DTEF, or foreign board of trade trading the contract would be required, before the temporary three-month grace period elapses, to change the composition of, or weightings of securities in, the index so that the index is not a narrow-based security index. Alternatively, the designated contract market, registered DTEF, or foreign board of trade trading a futures contract on such index could comply with the requirements of the securities laws applicable to security futures products.

Q4: Should the Commissions specify expressly the extent of changes a designated contract market, registered DTEF, or foreign board of trade needs to make to an index before the end of the temporary three-month grace period so that it does not need to comply with the securities laws applicable to markets trading security futures products? If so, commenters are asked for their views on what types of changes should be required.

#### b. Proposed Exclusion from the Definition of Narrow-Based Security Index During First 30 Days of Trading

To address the potential dislocation of market participants trading a future on an index that becomes narrow-based during the first 30 days of trading, and thus does not qualify for the statutory grace period under Section 1a(25)(D) of the CEA and Section 3(a)(55)(E) of the Exchange Act, the Commissions are proposing Rule 41.12 under the CEA and Rule 3a55-2 under the Exchange Act. These rules are being proposed pursuant to paragraph (vi) of Section 1a(25)(B) of the CEA and Section 3(a)(55)(C) of the Exchange Act, which permit the Commissions to establish, by rule, requirements for futures contracts on indexes that, if met, would provide additional exclusions from the definition of a "narrow-based security index."<sup>25</sup>

<sup>25</sup> Section 1a(25)(B)(vi) of the CEA and Section 3(a)(55)(C)(vi) of the Exchange Act provide that notwithstanding the definition of narrow-based security index, an index is not a narrow-based security if a futures contract 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]."

Specifically, the proposed rules would provide an exclusion from the definition of narrow-based security index for a futures contract that began trading on a security index that was not narrow-based and became narrow-based during the first 30 days after it began trading, if the index would not have been a narrow-based index, had it been in existence, for an uninterrupted period of 6 months prior to the first day of trading. The Commissions preliminarily believe that this six-month period is appropriate as an indication that the change in the index's character during the first 30 days was an anomaly, so that a temporary exclusion from the definition of a narrow-based security index is warranted.

The proposed rules provide, however, that an index that is not a narrow-based security index for the first 30 days of trading, as discussed above, *would* become a narrow-based security index if it has been a narrow-based security index for more than 45 business days over three consecutive calendar months, and would be a security future, with the attendant legal obligations, following an additional three-month grace period.

Q5: The Commissions request commenters to provide their views on proposed Rule 41.12 under the CEA and proposed Rule 3a55-2 under the Exchange Act. In particular, the Commissions request comment on their proposal that an index not be narrow-based for 6 months prior to a futures contract on such index commencing to trade in order for the exclusion in these proposed rules to apply. Is 6 months the appropriate time frame?

#### 3. Proposed Rule for Futures Contracts Traded on or Subject to the Rules of a Foreign Board of Trade

As noted above, the statutory definition of narrow-based security index set forth in Section 1a(25)(A) of the CEA and Section 3(a)(55)(B) of the Exchange Act, and the exclusions from that definition provided by Section 1a(25)(B) of the CEA and Section 3(a)(55)(C) of the Exchange Act, in effect also define a broad-based security index. The federal securities laws do not apply to futures contracts on broad-based security indexes. Prior to the enactment of the CFMA, futures contracts on broad-based security indexes were reviewed by both the CFTC and the SEC to ensure compliance with the provisions of the Shad-Johnson Accord. Specifically, this review evaluated whether the contract was cash-settled, not readily susceptible to manipulation, and represented a broad market segment. The CFMA altered the statutory requirements for approval of

broad-based indexes such that no approval or review is required by the SEC for these products.

With regard to security index futures traded on or subject to the rules of foreign boards of trade, the Commissions believe that security indexes underlying such contracts should be considered broad-based security indexes if they qualify as such pursuant to the statutory definition of a narrow-based index, or pursuant to the exclusions from that definition. The Commissions are proposing Rule 41.13 under the CEA and Rule 3a55-3 under the Exchange Act to clarify and establish that when a futures contract on an index is traded on or subject to the rules of a foreign board of trade, such index would not be a narrow-based security index (*i.e.*, it would be broad-based) if it would not be a narrow-based security index if a futures contract on such index were traded on a designated contract market or registered DTEF.<sup>26</sup> The Commissions recognize their obligation to jointly adopt rules or regulations that set forth the requirements that a futures contract on a security index traded on or subject to the rules of a foreign board of trade must meet in order for the index to be excluded from the definition of narrow-based security index and request comment on how rules relating to foreign broad-based indexes should address issues specific to indexes traded on or subject to the rules of a foreign board of trade.

Additionally, the Commissions note that Section 1a(25)(B)(v) of the CEA and Section 3(a)(55)(C)(v) of the Exchange Act create a "grandfather" provision that permits the offer and sale in the United States of security index futures traded on or subject to the rules of foreign boards of trade that were authorized by the CFTC before the CFMA was enacted.<sup>27</sup> This "grandfather" provision is in effect for 18 months after the CFMA's enactment, after which such indexes will be subject

<sup>26</sup> Section 1a(25)(B)(iv) of the CEA and Section 3(a)(55)(C)(iv) of the Exchange Act grant the Commissions joint authority to exclude an index underlying a futures contract from the definition of narrow-based security index when that index is traded on or subject to the rules of a foreign board of trade and meets such requirements that are established by rule or regulation jointly by the Commissions.

<sup>27</sup> Certain such futures contracts are currently offered to U.S. customers pursuant to no-action letters by the CFTC staff, to which the SEC did not object. The Commissions note that some of the index futures trading on or subject to the rules of foreign boards of trade that are trading pursuant to such no-action letters would not be considered to be broad-based index futures under Sections 1a(25)(A) or 1a(25)(B)(i) of the CEA and Sections 3(a)(55)(B) or 3(a)(55)(C)(i) of the Exchange Act.

to the ongoing requirements of the CEA and any new standard in effect thereafter.

The Commissions have identified and request comment on the following issues:

**Q6:** The Commissions ask for comment on their proposed rules. As noted above, the Commissions propose that the statutory definition of narrow-based security index under Section 1a(25)(A) of the CEA and Section 3(a)(55)(B) of the Exchange Act and the exclusion under Section 1a(25)(B)(i) of the CEA and Section 3(a)(55)(C)(i) of the Exchange Act would be applicable to futures on indexes traded on or subject to the rules of a foreign board of trade, including indexes comprised of domestic securities as well as those that are comprised primarily of securities traded on foreign markets. Would it be appropriate for the statutory definition and exclusion to be the sole criteria for index futures traded on or subject to the rules of a foreign board of trade?<sup>28</sup> If not, what issues should be considered in order to develop an additional exclusion from the statutory definition to describe whether an index that underlies a future trading on or subject to the rules of a foreign board of trade is broad-based?

**Q7:** What criteria should be set forth for futures on indexes traded on or subject to the rules of a foreign board of trade in order for such indexes to be considered broad-based? For example, commenters are asked for their views regarding criteria for the depth of the market, the concentration of the component securities, the permissibility of any affiliation among the issuers of component securities, the liquidity of component securities, and any other factors.

**Q8:** What provisions should be included to assure the accuracy of the information that is used to determine that the index is broad-based, in view of the fact that certain key data regarding such foreign securities is often not required to be disclosed.

**Q9:** If commenters believe that an additional exclusion is warranted, what are the unique characteristics of foreign securities and foreign securities markets that would argue in favor of a different standard for determining whether an index comprised of such securities is broad-based? Commenters are also

<sup>28</sup> The Commissions note that currently some futures contracts on indexes traded on or subject to the rules of foreign boards of trade are excluded from the definition of narrow-based security index solely under the "grandfather" provisions in Section 1a(25)(B)(v) of the CEA and Section 3(a)(55)(C)(v) of the Exchange Act, which terminate on June 21, 2002.

requested to provide their views on the impact of such a different standard on investor protection. Taking into account the nature and size of the markets for the securities underlying the index, is it appropriate to consider indexes comprised of foreign securities to be broad-based where those indexes are more concentrated in one or a few securities? Is it appropriate to consider indexes comprised of *foreign securities* to be broad-based, considering the nature and size of the underlying securities markets, if they are comprised of less liquid securities than would be permitted in a broad-based index, pursuant to the statutory definition of narrow-based security index? If so, please indicate why this is appropriate.

**Q10:** If a rule is adopted providing an additional exclusion from the definition of narrow-based security index for an index underlying a futures contract traded on or subject to the rules of a foreign board of trade, how should the Commissions address any potential competitive disadvantage to U.S. securities exchanges, alternative trading systems, designated contract markets, or registered DTEFs that might result from an additional exclusion?

**Q11:** How can the Commissions craft rules that avoid potential uncertainty as to the characterization of an index on an ongoing basis? How can the Commissions best design criteria that remain sound over time and do not introduce unforeseeable uncertainties into the regulatory and trading framework?

**Q12:** As noted above, certain futures contracts on indexes of foreign securities that are currently traded on foreign boards of trade (and in some cases, domestic contract markets) have been permitted to be offered to U.S. customers under CFTC no-action relief granted under standards that required such indexes to represent a broad segment of the cash market; the SEC did not object to such relief. Some of these indexes may become narrow-based security indexes in the absence of the "grandfather" provision described above. Would it be appropriate for the Commissions to use their authority under Section 1a(25)(B)(vi) of the CEA and Section 3(a)(55)(C)(vi) to jointly establish rules excluding such indexes or exclude such indexes by order?

**Q13:** The SEC asks for comment on whether an additional exclusion from the definition of narrow-based security index for index futures contracts traded on or subject to the rules of foreign boards of trade would be consistent with the purposes of the federal securities laws.

### III. Method for Determining Market Capitalization and Dollar Value of Average Daily Trading Volume

#### A. Determining Market Capitalization

As discussed above, an index is not a "narrow-based security index" under paragraph (B)(i) of Section 1a(25) of the CEA and paragraph (C)(i) of Section 3(a)(55) of the Exchange Act if, among other things, all of its component securities are among the Top 750 securities in terms of market capitalization. The Commissions are jointly proposing new rules under the CEA and the Exchange Act that would set forth the method for determining the market capitalization of a security.<sup>29</sup>

Paragraph (a)(1) of proposed Rule 41.11 under the CEA and proposed Rule 3a55-1 under the Exchange Act would establish that market capitalization is the product of: (1) the number of outstanding shares of the security as reported in the most recent quarterly or annual report of the company<sup>30</sup>—*i.e.*, Form 10-Q, 10-K, 10-QSB, 10-KSB, or 20-F;<sup>31</sup> and (2) the average price of the security over the preceding 6 full calendar months. The definitions of "average price" of a security and "preceding 6 full calendar months" are discussed in Parts III.D. and III.F. below.<sup>32</sup>

A national securities exchange, designated contract market, registered DTEF, or foreign board of trade that trades or proposes to trade a futures contract on a security index may contract with an outside party to supply the information and data analysis required to determine market capitalization. For example, the market trading the futures contract may have a contract with a data vendor that supplies transaction information through an electronic medium.

<sup>29</sup> The proposed method would apply only to calculating market capitalization of a security to determine whether it is a Top 750 security. Because the CFMA directs the two Commissions to specify a method for calculating market capitalization solely for this purpose, the sponsor or compiler of an index otherwise categorized as a market capitalization-weighted index would not be required to use the proposed method to determine the relative weightings of the index's component securities. See Section 1a(25)(E)(ii) of the CEA and Section 3(a)(55)(F)(ii) of the Exchange Act.

<sup>30</sup> To rely on this exclusion from the definition of narrow-based security index, all the component securities of an index must be registered pursuant to Section 12 of the Exchange Act. See Section 1a(25)(B)(i)(III)(aa) of the CEA and Section 3(a)(55)(C)(i)(III)(aa) of the Exchange Act. Therefore, information regarding the number of outstanding shares will be contained in the company's annual and periodic reports.

<sup>31</sup> 17 CFR Sections 249.308a, 249.310, 249.308b, 249.310b, and 249.220f.

<sup>32</sup> See *infra* notes 40-41 and 48-49 and accompanying text.

However, in these circumstances, the market would be responsible for determining that the calculation by the outside party is consistent with the Commissions' proposed rules.

**Q14:** The Commissions solicit comment on their proposed method for calculating the market capitalization of a security. In particular, are there other methods of calculating the market capitalization of a security that would be better for market participants to use? If so, are these alternatives as appropriate as the method proposed by the Commissions?

**Q15:** The Commissions also solicit comment on whether relying on the information reported by issuers to the SEC is the best way to determine the number of outstanding shares of a security.

**Q16:** It is possible that a corporate event affecting the number of shares outstanding of a security, such as a stock split, stock dividend, stock buyback, or merger, can occur after the filing by its issuer of an annual or periodic report. This may be particularly relevant in the case of foreign issuers that file with the SEC just once a year. Should the proposed rule specifically address such events, and, if so, how? For example, should national securities exchanges, designated contract markets, registered DTEFs, and foreign boards of trade be permitted to or be required to rely on updated information contained in any subsequent Form 8-K<sup>33</sup> filed by the issuer, or on more current information submitted to the primary market center for the underlying security? Are there reliable means other than SEC annual, periodic, and current reports to determine the current number of shares outstanding of a security in the event of a corporate event that results in a change in the number of outstanding shares?

**Q17:** The Commissions solicit comment on whether they should permit a national securities exchange, designated contract market, registered DTEF, or foreign board of trade to rely on an independent calculation of the market capitalization of a security by a third party. Should there be any conditions imposed when such a third party is used?

**Q18:** Do third parties, such as data vendors, calculate market capitalization using a different method than that proposed by the Commissions? If so, what are these methods? Should the Commissions incorporate these methods into the proposed rules? What would be the impact of any variation that may

result if the same calculations are made based on slightly different information?

**Q19:** If national securities exchanges, designated contract markets, registered DTEFs, and foreign boards of trade rely on the calculations of third parties, should those third parties be required to meet certain qualification standards? For example, should third parties be qualified only if data dissemination and calculation is part of their regular business? Should notification to the Commissions be required if a third party's calculations are used?

#### *B. Determining Dollar Value of Average Daily Trading Volume*

Dollar value of ADTV is used in two provisions of the definition of "narrow-based security index."<sup>34</sup> As required by the CFMA, the Commissions are proposing rules that would set forth the method for determining an individual security's dollar value of ADTV. Specifically, paragraph (a)(2) of proposed Rule 41.11 under the CEA and proposed Rule 3a55-1 under the Exchange Act would establish that dollar value of ADTV is the product of: (1) the average daily trading volume of the security over the preceding 6 full calendar months; and (2) the average price of the security over the preceding 6 full calendar months.

The Commissions believe that multiplying a security's average daily trading volume over the preceding 6 full calendar months by its average price over the same period is a reasonable and simple method to use to determine the dollar value of its ADTV. The definitions of "average price" of a security and "preceding 6 full calendar months," are discussed in Parts III.D. and III.F. below.

A national securities exchange, designated contract market, registered DTEF, or foreign board of trade that trades or proposes to trade a futures contract on a security index may contract with a third party information provider to calculate, or provide the information necessary to calculate, the dollar value of ADTV. The market, however, would be responsible for determining that such calculation is consistent with the Commissions' proposed rules.

**Q20:** The Commissions solicit comments on their proposed method of calculating a security's dollar value of ADTV.

**Q21:** The Commissions are also interested in commenters' views on whether alternative ways to calculate

this value would be more accurate or less burdensome to compute. For example, should the dollar value of ADTV of a security be calculated by multiplying the number of shares in each transaction by the price at which the transaction took place, then summing these values for each day in the six-month period, and finally dividing that sum by the number of trading days in the six-month period?

**Q22:** While the security of an issuer that underlies an American Depository Receipt ("ADR") must be registered under Section 12 of the Exchange Act, the ADR itself is deemed to be a separate security and is exempt from registration under Section 12. The Commissions solicit comments on whether, when determining the ADTV of a security, the ADTV of ADRs representing shares of such security should be included. The Commissions also solicit comment on whether, when determining average price of a security, the average price, on a proportional basis, of ADRs representing shares of such security should be considered.

**Q23:** For purposes of the exclusion from the definition of narrow-based security index in Section 1a(25)(B)(i) of the CEA and Section 3(a)(55)(C)(i) of the Exchange Act, should an ADR be considered registered pursuant to Section 12 of the Exchange Act if its underlying security is so registered?

**Q24:** The Commissions solicit comment on whether they should permit a national securities exchange, designated contract market, registered DTEF, or foreign board of trade to rely on an independent calculation of the dollar value of ADTV of a security by a third party. Should there be any conditions imposed when such a third party is used?

**Q25:** Do third parties, such as data vendors, calculate dollar value of ADTV using a different method than that proposed by the Commissions? If so, what are those methods? Should the Commissions incorporate these methods into the proposed rules? What would be the impact of any variation that may result if the same calculations are made based on slightly different information?

**Q26:** If national securities exchanges, designated contract markets, registered DTEFs, and foreign boards of trade rely on the calculations of third parties, should those third parties be required to meet certain qualification standards? For example, should third parties be qualified only if data dissemination and calculation is part of their regular business? Should notification to the Commissions be required if a third party's calculations are used?

<sup>34</sup> Section 1a(25)(A)(iv) and (B)(i) of the CEA and Section 3(a)(55)(B)(iv) and (C)(i) of the Exchange Act.

<sup>33</sup> 17 CFR 249.308.

### C. Determining Average Daily Trading Volume

Paragraph (b)(1) of Proposed Rule 41.11 under the CEA and proposed Rule 3a55-1 under the Exchange Act would define the ADTV of a security as the total number of shares of such security traded on the trading days of the principal market for the security<sup>35</sup> during the preceding 6 full calendar months divided by the number of trading days on the principal market for the security during the same period.<sup>36</sup> The inclusion of foreign trading data is discussed in Part III.E. below.<sup>37</sup>

Q27: The Commissions request comment on the proposed definition of ADTV.

Are there other, more appropriate ways to determine ADTV?

### D. Determining Average Price

#### 1. Basic Definition

The proposed methods for determining market capitalization and dollar value of ADTV require assessing the average price of a security over the preceding 6 full calendar month period. Paragraph (b)(2)(i) of proposed Rule 41.11 under the CEA and proposed Rule 3a55-1 under the Exchange Act would establish a method that takes into account the number of shares in each transaction in calculating the average price of a security. This method, often termed "volume-weighted average price," would require that there first be established a value for each transaction, by multiplying the price per share in U.S. dollars of each transaction by the number of shares traded in that transaction. Then, the sum of these values for all the transactions in the security during the 6-month period is divided by the total number of shares traded during that period. The inclusion of foreign trading data is discussed in Part III.E. below.<sup>38</sup>

Q28: The Commissions request commenters' views on the proposed method for calculating a security's "average price." Are there other methods that would be more appropriate? For example, another way to determine "average price" is to use the closing price of the security for each day of the preceding 6 full calendar months averaged over that same 6-month period. Should the rules permit

<sup>35</sup> The principal market for a security is proposed to mean the single market with the largest aggregate reported trading volume for the security during the preceding 6 full calendar months. See Paragraph (b)(7) of proposed Rule 41.11 under the CEA and proposed Rule 3a55-1 under the Exchange Act.

<sup>36</sup> See below in Part III.E. regarding the proposed limitation of trading days to "trading days of the principal market for the security."

<sup>37</sup> See *infra* notes 42-47 and accompanying text.

<sup>38</sup> *Id.*

the use of the average closing price of a security to calculate dollar value of ADTV instead of requiring an overall average price based on transactions throughout the day?

Q29: Do third parties, such as data vendors, calculate the average price of a security using a different method than that proposed by the Commissions? If so, what are those methods? Should the Commissions incorporate these methods into the proposed rules?

Q30: If national securities exchanges, designated contract markets, registered DTEFs, and foreign boards of trade rely on the calculations of third parties, should those third parties be required to meet certain qualification standards? For example, should third parties be qualified only if data dissemination and calculation is part of their regular business? Should notification to the Commissions be required if a third party's calculations are used?

#### 2. Exception Permitting Use of Non-Volume-Weighted Average Price for Certain Calculations

Paragraph (b)(2)(ii) of proposed Rule 41.11 under the CEA and proposed Rule 3a55-1 under the Exchange Act would permit the use of a non-volume-weighted average price under certain conditions. Specifically, for purposes of determining whether the dollar value of ADTV of the lowest weighted 25% of a security index exceeds the statutory threshold<sup>39</sup> of \$50 million (or \$30 million for indexes with 15 or more component securities), national securities exchanges, designated contract markets, registered DTEFs, and foreign boards of trade would be permitted to use an average price for each component security defined as the average price level at which transactions in the security took place over the six-month period, irrespective of the number of shares traded in each transaction.<sup>40</sup>

Such non-volume-weighted average price may be easier to calculate than a volume-weighted average price, and the Commissions preliminarily believe that it would be a reasonable alternative for purposes of this one aspect of the statutory definition of narrow-based security index.<sup>41</sup> However, because the

<sup>39</sup> See Section 1a(25)(A)(iv) of the CEA and Section 3(a)(55)(B)(iv) of the Exchange Act.

<sup>40</sup> *Id.*

<sup>41</sup> The Commissions do not believe it appropriate to permit the use of an alternative method to true, volume-weighted average price for purposes of the other statutory tests that require the use of average price. If a choice of methods was permitted for these other tests—which require determining whether a security is one of the Top 750 and Top 675 securities in terms of market capitalization and dollar value of ADTV—different markets might arrive at different lists of the Top 750 and Top 675

method does not take into account the volume of shares traded at each price, and thus yields only an approximation of a security's true average price, the Commissions are proposing to permit its use subject to a limitation.

Sometimes, the dollar value of ADTV of the lowest weighted 25% of an index, when based on the non-volume-weighted average price of each security comprising it, may exceed the statutory threshold, while the *real* dollar value of its ADTV—based on the more exact, volume-weighted figures for average price of each security—falls short. Accordingly, paragraphs (a)(2)(iii) and (b)(2)(ii) of proposed Rule 41.11 under the CEA and proposed Rule 3a55-1 under the Exchange Act would stipulate that this method may be used only when the dollar value of ADTV of the lowest weighted 25% of an index based on this method equals or exceeds \$55 million (or \$33 million for indexes with 15 or more component securities)—*i.e.*, it exceeds the statutory thresholds of \$50 million (or \$30 million for indexes with 15 or more component securities) by at least 10%. If it does not, the average price of securities must be calculated using the volume-weighted average price method in paragraph (a)(2)(i) of the proposed rules. The Commissions preliminarily believe that when the dollar value of ADTV of a security index exceeds the \$50 million threshold (or the \$30 million threshold, as the case may be) by 10% when using the non-volume weighted price, the security index would most likely exceed those thresholds if the volume-weighted average price test was used.

Q31: The Commissions request comment on this proposed alternative method for calculating average price for purposes of determining whether the dollar value of ADTV of the lowest weighted 25% of an index equals or exceeds \$55 million (or \$33 million, for indexes with 15 or more component securities). Is the 10% threshold appropriate? Should it be higher or lower?

### E. Component Securities of an Index That Trade in Foreign Markets

Security indexes may contain a number of securities that are registered under Section 12 of the Exchange Act and traded in the United States and that may also trade in markets outside the United States.

Paragraphs (b)(1) and (b)(2)(i) and (ii) of proposed Rule 41.11 under the CEA

securities. As a result, the same index could be deemed a narrow-based security index in one market and a broad-based index in another.



and proposed Rule 3a55-1 under the Exchange Act would permit data from non-U.S. markets to be included in determining the average daily trading volume and average price of a security, provided that the information has been reported to a foreign financial regulatory authority<sup>42</sup> in the jurisdiction where the security is traded. The Commissions preliminarily believe that it is reasonable to allow markets to include such non-U.S. trading volume in determining the total dollar value of a security's ADTV.<sup>43</sup> To the extent that trades that are executed on non-U.S. markets are included in the calculation of a security's ADTV, the proposed rules would also require those same trades to be included in calculating the security's average price.<sup>44</sup>

In addition, paragraph (b)(2)(ii) and (iii) of proposed Rule 41.11 under the CEA and proposed Rule 3a55-1 under the Exchange Act would allow price information from non-U.S. markets to be figured into the average price only when the price for each transaction included in that calculation is translated into U.S. dollars at the trading date's noon buying rate in New York City for cable transfers in foreign currencies as certified for customs purposes by the Federal Reserve Bank of New York ("noon buying rate").<sup>45</sup>

Finally, the Commissions recognize that because the trading days in various countries do not necessarily conform to each other, a uniform standard would be appropriate. To assure consistency, the proposed rules would permit price and trading volume data for each security to be included only for the trading days of the "principal market for the security."<sup>46</sup> "Principal market" for a security is defined as the single market with the largest aggregate reported

trading volume for the security during the preceding 6 full calendar months.<sup>47</sup>

*Q32:* Do the proposed rules adequately allow foreign trading volume to be included? Is information regarding non-U.S. trading volume for the preceding 6 full calendar months readily available?

*Q33:* The Commissions solicit comment specifically on the proposed requirement that the exchange rate used be the noon buying rate. Are rates readily available for all currencies in which securities may trade worldwide? How should the rule account for the possibility that trades occur on days when the noon buying rate is unavailable? For example, should the rule require that the prior day's rate, or an average rate over a period of time, be used? Is another exchange rate method preferable to the noon buying rate, and if so, which exchange rate method?

*Q34:* The Commissions also solicit comment specifically on the proposed limitation on the use of market data to data for the trading days of the principal market of the security. Is there an alternative way to take into account the fact that trading calendars in various countries are not always synchronous? For example, one alternative way is to calculate the dollar value of ADTV over the preceding 6 full calendar months separately for each securities market where the security trades, based on that market's own trading calendar (and taking into account the appropriate exchange rate), and then to sum the dollar value of ADTV over the preceding 6 full calendar months for all the securities markets. What would be the advantages and disadvantages of such an approach? Commenters are asked to provide specific examples of how to determine both ADTV and average price if data from various securities markets for all trading days is to be included.

*Q35:* Commenters are requested to provide their views regarding whether any other issues relating to foreign trading data need to be addressed.

#### *F. Determining "the Preceding 6 Full Calendar Months"*

The CEA and Exchange Act specify that the dollar value of ADTV and market capitalization shall be calculated as of the "preceding 6 full calendar months."<sup>48</sup> Paragraph (b)(5) of proposed Rules 41.11 under the CEA and 3a55-1 under the Exchange Act would 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 such day, and ending on the day prior to such day. For example, for August 16 of a particular year, the preceding 6 full calendar months means the period beginning February 16 and ending August 15. Similarly, for March 8 of a particular year, the 6-month period begins on September 8 of the previous year and ends on March 7.

The Commissions believe that this "rolling" 6-month approach is appropriate, particularly in light of issues that would arise if 6 full calendar months were measured from the first to the last day of each month on the calendar. If that approach were used, it would be difficult to apply the CEA and Exchange Act provisions excepting a security index from the definition of narrow-based security index if, among other things, it is narrow-based for 45 or fewer business days in a three-month period.<sup>49</sup>

For example, if a national securities exchange, designated contract market, registered DTEF, or foreign board of trade needed to assess the dollar value of ADTV for the six months preceding July 20, and the measuring period for which the dollar value of ADTV for the component securities of an index is determined as the 6-month period from January 1 through June 30, the dollar value of ADTV would be static for each day in July. In this example, the calculation would not take into account any transactions that occurred during July. Thus, if this approach were used to define the 6-month period, the Commissions believe it would leave meaningless the statutes' provisions concerning the number of days within a three-month period that a future on an index that is narrow-based may continue to trade under the regulatory framework for futures on indexes that are not narrow-based.

*Q36:* Is there an approach other than the one proposed to determine the preceding 6 full calendar months? How would such an alternative work in applying the provision that excludes a non-narrow based index future that becomes narrow-based from the definition of a narrow-based security index future if it is narrow-based for 45 or fewer days in a three month period?

#### *G. The Lowest Weighted 25% of an Index*

As discussed in Part II.A. above, one of the factors that may render a security index narrow-based is if the aggregate dollar value of the ADTV of the lowest

<sup>42</sup> "Foreign financial regulatory authority" is defined in the paragraph (b)(3) of proposed Rule 41.11 under the CEA and proposed Rule 3a55-1 under the Exchange Act to have the same meaning as in Section 3(a)(52) of the Exchange Act.

<sup>43</sup> The use of foreign trading data could also affect average price for purposes of determining market capitalization, although the Commissions do not believe that the impact would be significant.

<sup>44</sup> See paragraph (b)(2)(iv) of proposed Rule 41.11 under the CEA and proposed Rule 3a55-1 under the Exchange Act.

<sup>45</sup> See also 17 CFR 229.301 (Instructions to Item 301, No. 7), which similarly requires registrants to use the noon buying rate for purposes of determining the rate of exchange for selected financial data included in registration statements under the Securities Act and periodic reports under the Exchange Act.

<sup>46</sup> See paragraphs (b)(1) and (b)(2)(i) and (ii) of proposed Rule 41.11 under the CEA and proposed Rule 3a55-1 under the Exchange Act.

<sup>47</sup> Paragraph (b)(7) of proposed Rule 41.11 under the CEA and proposed Rule 3a55-1 under the Exchange Act.

<sup>48</sup> Section 1a(25)(E)(i) of the CEA and Section 3(a)(55)(F)(i) of the Exchange Act.

<sup>49</sup> Sections 1a(25)(B)(iii) and (D) of the CEA and Sections 3(a)(55)(C)(iii) and (E) of the Exchange Act.

weighted 25% of its component securities is less than \$50 million (or \$30 million for an index of 15 component securities or more).<sup>50</sup>

The proposed rules would establish that the “lowest weighted 25% of an index’s weighting” is comprised of those component securities that have the lowest weightings in the index such that, when their weightings are summed, they equal no more than 25% of the weight of the index.<sup>51</sup> To identify these securities, the following method would apply: (1) all component securities in an index would be ranked from the lowest to highest weighting; and (2) beginning with the lowest weighted security and proceeding to the next lowest weighted security and continuing in this manner, the weightings would be added to each other until they reach the sum that would come closest to, or equal 25%, but would not exceed 25%. Those securities would then comprise the lowest weighted 25% of the index.

In addition, the calculation of ADTV and its dollar value for any given moment in time must take into account trading volume and price data for the relevant securities over the preceding 6 months of trading. Yet the securities that comprise the lowest weighted 25% of an index may vary from day to day. The proposed rules establish how the ADTV of the lowest weighted 25% of an index and its dollar value is to be determined.

Specifically, the proposed rules would establish that, for any particular day, the ADTV of the lowest weighted 25% of the index is calculated based on the price and trading data over the preceding 6 months for the securities that comprise the lowest weighted 25% of the index *for that day*. The Commissions believe that this method of taking a “snapshot” of the current lowest weighted 25% and then looking retroactively to determine the aggregate dollar value of the ADTV over the preceding 6 months of the securities in the snapshot is a reasonable approach for the purposes of the statute and would be considerably less burdensome than the alternative of requiring a calculation of the data for the lowest weighted 25% of the index for each day of the preceding 6 full calendar months.

<sup>50</sup> Section 1a(25)(A)(iv) of the CEA and Section 3(a)(55)(B)(iv) of the Exchange Act.

<sup>51</sup> Paragraph (b)(4) of proposed Rule 41.11 under the CEA and proposed Rule 3a55-1 under the Exchange Act. Paragraph (b)(9) of the proposed rules, respectively, would clarify that “weighting” of a component security of an index means the percentage of the index’s value represented or accounted for by that component security.

*Q37:* The Commissions request comment concerning whether the method for identifying the securities comprising the lowest weighted 25% of an index’s weighting is practicable. Is there any other approach the Commissions should consider?

#### IV. Transitional Exemption for Broad-Based Index Futures

As discussed above, the statutory definition of narrow-based security index provides a temporary exclusion under certain conditions for a futures contract trading on an index that was not narrow-based and subsequently became narrow-based for no more than 45 business days over three consecutive calendar months. If the index becomes narrow-based for more than 45 days over three consecutive calendar months, the statute then provides a grace period of three months during which the index is excluded from the definition of narrow-based security index.<sup>52</sup>

The CFTC is proposing to adopt Rule 41.14 under the CEA to provide a similar temporary exclusion and transitional grace period for a security futures product that was trading on a narrow-based security index that becomes a broad-based index. Paragraph (a) of proposed Rule 41.14 under the CEA would establish a temporary exclusion for a security future that began trading on an index that was narrow-based and subsequently became broad-based for no more than 45 days in a three-month calendar period. In such case the index would continue to be considered narrow-based. Paragraph (b) of proposed Rule 41.14 would provide a transition period for an index that was a narrow-based security index and became broad-based for more than 45 days over three consecutive calendar months, permitting it to continue to be a narrow-based security index for the three following calendar months.<sup>53</sup>

To minimize disruption, paragraph (c) of the proposed CEA rule also provides that a national securities exchange may, following the transition period, continue to trade only in those months in which the contract had open interest on the date the transition period ended and shall limit trading to liquidating positions. The Commissions note that a national securities exchange that intends to trade an index following the end of the transition period, other than as specified in paragraph (b), would be required to take such action as may be necessary to trade the index as a broad-

<sup>52</sup> See *supra*, Part II.B.2.

<sup>53</sup> Proposed Rule 41.1(a) under the CEA would define “broad-based security index” as “a group or index of securities that does not constitute a narrow-based security index.”

based index subject to the sole jurisdiction of the CFTC.<sup>54</sup>

#### V. Request for Comments

The Commissions solicit comments on all aspects of proposed Rules 41.1 and 41.2 and Rules 41.10 through 41.14 under the CEA and proposed Rules 3a55-1 through 3a55-3 under the Exchange Act. In particular, the Commissions seek comments on whether the proposed methods for determining the market capitalization and dollar value of ADTV are appropriate, or whether other calculation methodologies would be more suitable. In suggesting other methodologies, commenters should provide specific examples. Commenters are welcome to offer their views on any other matter raised by the proposed rules.

#### VI. Paperwork Reduction Act CFTC

##### A. Summary of Collection of Information

The Paperwork Reduction Act (“PRA”) of 1995<sup>55</sup> imposes certain requirements on federal agencies (including the CFTC) in connection with their conducting or sponsoring any collection of information as defined by the PRA.

Futures contracts on security indexes that meet the statutory definition of narrow-based security index are jointly regulated by the SEC and CFTC. Futures contracts on indexes that do not meet the statutory definition of narrow-based remain under the sole jurisdiction of the CFTC. To implement the definition of a narrow-based security index, the Commissions are required to jointly specify by rule or regulation the method for determining market capitalization and dollar value of ADTV of securities comprising an index.

In addition, the CFMA amended the CEA by requiring national securities exchanges that deal in security futures products to become designated contract markets solely for the purpose of trading security futures products (“notice-registered contract markets”).<sup>56</sup>

A designated contract market or registered DTEF that trades or proposes to trade a futures contract on a security index must ascertain whether or not the security index falls within the definition of narrow-based security index to determine the jurisdiction under which trading in such contract falls, and whether the market in which it trades is

<sup>54</sup> See Section 2(a)(1)(C)(ii) of the CEA.

<sup>55</sup> 44 U.S.C. 3504(h).

<sup>56</sup> See Sections 2(a)(1)(D)(ii) and 5f of the CEA.

in compliance with the relevant securities and commodities laws. This will entail, among other things, a collection of the information necessary to make the requisite determination under the provisions of the CEA and the Exchange Act regarding the market capitalization and dollar value of ADTV of individual securities or groups of securities comprising the index.

The proposed rules would provide the method by which a market trading a futures contract on a security index must determine the market capitalization and dollar value of ADTV of securities comprising the index in order to assure that it is in compliance with the applicable requirements of the CEA and the Exchange Act.

Proposed Rule 41.2 requires designated contract markets (including notice-registered contract markets) and registered DTEFs that trade a security index or security futures product to maintain, in accordance with the requirements of Rule 1.31, books and records of all activities relating to the trading of such products. This proposed rule restates the existing recordkeeping requirements of the CEA.<sup>57</sup> The proposed rule also specifies that, in order to comply with these recordkeeping requirements, designated contract markets and registered DTEFs that trade futures contracts on security indexes and security futures products would be required to preserve records of any calculations used to determine whether an index is broad-based or narrow-based.

#### *B. Proposed Use of Information*

Designated contract markets and registered DTEFs that wish to trade futures contracts on a security index would use the methods specified in the proposed rules to determine market capitalization and dollar value of ADTV of a security or a group of securities comprising the index. These determinations would enable these designated contract markets and registered DTEFs to ascertain whether a security index on which they propose to trade or are trading a futures contract is "narrow-based," and thus subject to the joint jurisdiction of the SEC and the CFTC, or is "broad-based," and thus subject to the exclusive jurisdiction of the CFTC.

Any market that trades a futures contract on a broad-based or narrow-based security index would be required to retain records of its determinations as required by the recordkeeping requirements of the proposed rules.

#### *C. Respondents*

The only entities required under the proposed rules to retain such records would be designated contract markets (including notice-registered contract markets) and registered DTEFs that trade futures contracts on security indexes. The CFTC estimates that potentially 11 designated contract markets (of which four would be notice-registered) would be required by the proposed rules to comply with these recordkeeping requirements. No registered DTEFs are currently trading futures products. The CFTC requests comment on whether any additional entities would be required to keep these records.

#### *D. Total Annual Reporting and Recordkeeping Burden*

##### 1. Capital Costs

Designated contract markets (including notice-registered contract markets) and registered DTEFs that trade futures contracts on security indexes would be required to keep on file all records concerning their determinations that such indexes were either broad-based or narrow-based for a period of five years, of which the first two years of such records would be required to be readily accessible. Because these markets are already required to have recordkeeping systems in place, the CFTC preliminarily estimates that any additional costs of retaining and storing the collected information discussed above would be nominal. The CFTC is soliciting comment on this finding.

##### 2. Burden Hours

Designated contract markets and registered DTEFs that trade futures contracts on security indexes would be required to retain and store the determinations of market capitalization and dollar value of ADTV obtained by applying the methods provided by the proposed rules for five years; of which the first two years of such records would be required to be readily accessible. The CFTC estimates that it would take the 11 respondents one hour each to retain any documents made or received by it in determining whether an index is narrow-based or broad-based. The total burden in complying with proposed rule 41.2 would be 11 hours. The CFTC is soliciting comment on this estimate.

#### *E. General Information About the Collection of Information*

The collection of information required by the proposed rules is mandatory and would need to be retained by designated

contract markets and registered DTEFs for five years, and for the first two years the information must be readily accessible. An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless it displays a currently valid OMB control number.

#### *F. Request for Comment*

The CFTC requests comments: (1) on whether the proposed collection of information is necessary for the proposed performance of the functions of the agency, including whether the information shall have practical utility; (2) to evaluate the accuracy of the CFTC's estimate of the burden of the proposed collection of information; (3) on whether the proposed collection of information will enhance the quality, utility, and clarity of the information to be collected; and (4) whether the proposed collection of information will minimize the burden of collection on those who are to respond, including through the use of electronic or automated collection techniques or other forms of information technology.

Persons wishing to submit comments on the collection of information requirements should direct them to the Office of Information and Regulatory Affairs, OMB, Room 10235, New Executive Office Building, Washington, DC 20503, Attention: Desk Officer for the CFTC, and to the Commodity Futures Trading Commission, Three Lafayette Centre, 1155 21st Street, NW, Washington, DC 20581, Attention: Office of the Secretariat. Comments may be sent by facsimile transmission to (202) 418-5521 or by e-mail to [secretary@cftc.gov](mailto:secretary@cftc.gov). Reference should be made to Narrow-Based Security Indexes.

The CFTC has submitted the proposed collection of information to OMB for approval. Members of the public should direct any general comments to both the CFTC and OMB within 30 days. OMB is required to make a decision concerning the collection of information between 30 and 60 days after publication in the **Federal Register**, so a comment to OMB is best assured of having its full effect if OMB receives it within 30 days of publication of this release. Requests for the materials submitted to OMB by the CFTC with regard to this collection of information are available from the CFTC Clearance Officer, Three Lafayette Centre, 1155 21st Street, NW, Washington, DC 20581, Telephone: (202) 418-5160.

#### **SEC**

Certain provisions of the proposed rules contain "collection of information" requirements within the

<sup>57</sup> See Sections 5(d)(17) and 5a(d)(8) of the CEA.

meaning of the Paperwork Reduction Act of 1995 ("PRA"),<sup>58</sup> and the SEC has submitted them to the Office of Management and Budget ("OMB") for review in accordance with 44 U.S.C. 3507(d) and 5 CFR 1320.11. The SEC is proposing to amend the collection of information entitled "Rule 17a-1: Recordkeeping rule for national securities exchanges, national securities associations, registered clearing agencies, and the Municipal Securities Rulemaking Board" (OMB Control Number 3235-0208). An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information, unless it displays a currently valid OMB control number.

#### A. Summary of Collection of Information

As noted above, the CFMA lifted the ban on trading single stock and narrow-based stock index futures and established a framework for the joint regulation of these products by the SEC and the CFTC. In addition, the CFMA amended the Exchange Act and CEA by adding a definition of "narrow-based security index," which establishes an objective test of whether a security index is narrow-based.<sup>59</sup> Futures contracts on security indexes that meet the statutory definition of narrow-based security index are jointly regulated by the SEC and the CFTC. Futures contracts on indexes that do not meet the statutory definition of narrow-based security index remain under the sole jurisdiction of the CFTC. To implement the definition of a narrow-based security index, the Commissions are required to specify jointly by rule or regulation the method for determining market capitalization and dollar value of ADTV of securities comprising an index.<sup>60</sup>

In addition, the CFMA amended the Exchange Act by adding new Section 6(g), which would require an exchange that is a designated contract market or a registered DTEF that lists or trades security futures products to register as a national securities exchange ("notice-registered national securities exchange") solely for the purpose of trading security futures products.<sup>61</sup>

A national securities exchange, designated contract market, registered DTEF, or foreign board of trade that trades or proposes to trade a futures contract on a security index must ascertain whether or not the security

index falls within the definition of narrow-based security index to determine the jurisdiction under which trading in such contract falls, and whether the market in which it trades is in compliance with the relevant securities and commodities laws. This will entail, among other things, a collection of the information necessary to make the requisite determination under the provisions of the Exchange Act and the CEA regarding the market capitalization and dollar value of ADTV of individual securities or groups of securities comprising the index.

Proposed Rule 3a55-1 under the Exchange Act specifies the method to determine market capitalization and dollar value of ADTV of index securities.<sup>62</sup> Thus, the proposed rule would provide the method by which a market trading a futures contract on a security index must determine the market capitalization and dollar value of ADTV of index securities in order to assure that it is in compliance with the applicable requirements of the Exchange Act and the CEA.

Rule 17a-1 under the Exchange Act,<sup>63</sup> among other things, requires national securities exchanges, which by definition include entities registered under the new notice registration provisions of the Exchange Act,<sup>64</sup> to retain copies of all documents, including all correspondence, memoranda, papers, books, notices, accounts, and other records made or received by them in the course of their business and in the conduct of their self-regulatory activities for a period of not less than five years, in the first two years in an easily accessible place. Any exchange that lists or trades a futures contract on a narrow-based security index product must be registered with the SEC pursuant to Section 6 of the Exchange Act and, as a registered national securities exchange, will be subject to the recordkeeping requirements of Rule 17a-1. Rule 17a-1 thus will apply to any notice-registered national securities exchange. Accordingly, in order to comply with these recordkeeping requirements, a national securities exchange, including a notice-registered national securities exchange, that lists or trades futures contracts on narrow-based security indexes would be required to preserve records of any calculations used to

determine whether an index is narrow-based.<sup>65</sup>

#### B. Proposed Use of Information

National securities exchanges, designated contract markets, registered DTEFs, and foreign boards of trade would use the methods specified in the proposed rules to determine market capitalization and dollar value of ADTV of a security or a group of securities comprising the index. These determinations would enable these national securities exchanges, designated contract markets, registered DTEFs, and foreign boards of trade to ascertain whether a security index on which they propose to trade or are trading a futures contract is "narrow-based," and thus is subject to the joint jurisdiction of the SEC and CFTC. If the market determined that the index is not narrow-based under the proposed rules' methodology, the futures contract would be solely under the CFTC's jurisdiction.

The SEC will use the collected information to monitor the accuracy of the determinations made by national securities exchanges, including notice-registered national securities exchanges, as to whether a security index is narrow-based.

Any national securities exchange, including any notice-registered national securities exchange, that trades a futures contract on a narrow-based security index would be required to retain records of its determinations pursuant to the recordkeeping requirements of Rule 17a-1.

#### C. Respondents

The only entities required under Rule 17a-1 under the Exchange Act to retain such records would be national securities exchanges (including designated contract markets and registered DTEFs registered as national securities exchanges pursuant to Section 6(g) of the Exchange Act) that trade futures contracts on narrow-based security indexes. The SEC estimates that potentially 4 national securities exchanges and 7 notice-registered national securities exchanges (designated contract markets registered pursuant to Section 6(g) of the Exchange

<sup>58</sup> This PRA analysis does not include any collection of information and recordkeeping requirements that would apply to designated contract markets, registered DTEFs, and foreign boards of trade that trade futures contracts on security indexes that are not narrow-based because the trading of these products is not subject to the SEC's jurisdiction. Therefore, such information and recordkeeping would not be subject to Rule 17a-1 under the Exchange Act.

<sup>58</sup> 44 U.S.C. 3501 *et seq.*

<sup>59</sup> See Section 1a(25)(A) of the CEA and Section 3(a)(55)(B) of the Exchange Act.

<sup>60</sup> Section 3(a)(55)(F) of the Exchange Act and Section 1a(25)(E) of the CEA.

<sup>61</sup> See Section 6(g) of the Exchange Act, 15 U.S.C. 78f(g).

<sup>62</sup> Proposed Rule 41.11 under the CEA parallels proposed Rule 3a55-1.

<sup>63</sup> 17 CFR 240.17a-1.

<sup>64</sup> See Section 6 of the Exchange Act, 15 U.S.C. 78f.

Act)<sup>66</sup> would be required by the Exchange Act and the rules thereunder to comply with these recordkeeping requirements. No registered DTEFs are currently trading futures products. The SEC requests comment on whether any additional entities would be required to keep these records.

#### *D. Total Annual Reporting and Recordkeeping Burden*

##### 1. Capital Costs

Rule 17a-1 under the Exchange Act would require national securities exchanges, including any notice-registered national securities exchanges, that trade futures contracts on narrow-based security indexes to keep on file for a period of no less than five years, the first two years in an easily accessible place, all records concerning their determinations that such indexes were narrow-based.<sup>67</sup> Because national securities exchanges, including notice-registered national securities exchanges that have been designated contract markets with the CFTC, currently are required to have recordkeeping systems in place,<sup>68</sup> the SEC preliminarily estimates that any additional costs of retaining and storing the collected information discussed above would be nominal. The SEC is soliciting comment on this estimation.

##### 2. Burden Hours

National securities exchanges, including notice-registered national securities exchanges, that trade futures contracts on security indexes would be required to comply with the recordkeeping requirements under Rule 17a-1 under the Exchange Act.<sup>69</sup> National securities exchanges, including notice-registered national securities exchanges, would be required to retain and store any documents related to determinations made using the definitions in proposed Exchange Act Rule 3a55-1 for no less than five years, the first two years in an easily accessible place. The current burden estimate for Rule 17a-1, as of July 20, 1998, is 50 hours per year for each exchange.<sup>70</sup> The SEC estimates that it would take each of

the 11 respondents one hour annually to retain any documents made or received by it in determining whether an index is a narrow-based security index. The total burden in complying with Rule 17a-1 for each national securities exchange, including notice registered national securities exchanges, under proposed Rule 3a55-1 would be 11 hours. The SEC is soliciting comment on this estimate.

#### *E. General Information About the Collection of Information*

The collection of information required by the proposed rules is mandatory and would need to be retained by the national securities exchanges and notice-registered national securities exchanges for no less than five years, and for the first two years the information must be in an easily accessible place, as required under Exchange Act Rule 17a-1. Under Rule 17a-1, the information collected pursuant to the proposed rules would be retained by the national securities exchange or the notice-registered national securities exchange that is relying on the proposed rules. The SEC would obtain access to the information upon request. Any collection of information received by the SEC would not be made public.

#### *F. Request for Comment*

Pursuant to 44 U.S.C. 3506(c)(2)(B), the SEC solicits comments to: (1) evaluate whether the proposed collection of information is necessary for the proposed performance of the functions of the agency, including whether the information shall have practical utility; (2) evaluate the accuracy of the SEC's estimate of the burden of the proposed collection of information; (3) enhance the quality, utility, and the clarity of the information to be collected; and (4) minimize the burden of collection on those who are to respond, including through the use of electronic or automated collection techniques or other forms of information technology.

Persons wishing to submit comments on the collection of information requirements should direct them to the following persons: (1) Desk Officer for the Securities and Exchange Commission, Office of Information and Regulatory Affairs, Office of Management and Budget, Washington, D.C. 20503; and (2) Jonathan G. Katz, Secretary, Securities and Exchange Commission, 450 Fifth Street, N.W., Washington, D.C. 20549-0609, with reference to File No. S7-11-01.

The SEC has submitted the proposed collection of information to OMB for

approval. Members of the public should direct any general comments to both the SEC and OMB within 30 days. OMB is required to make a decision concerning the collection of information between 30 and 60 days after publication in the **Federal Register**, so a comment to OMB is best assured of having its full effect if OMB receives it within 30 days of publication of this release. Requests for the materials submitted to OMB by the SEC with regard to this collection of information should be in writing, refer to File No. S7-11-01, and be submitted to the Securities and Exchange Commission, Records Management, Office of Filings and Information Services, 450 Fifth Street, N.W., Washington, D.C. 20549-0609.

#### **VII. Costs and Benefits of the Proposed Rules**

##### **CFTC**

Section 15(a) of the CEA requires the CFTC to consider the costs and benefits of its action before issuing a new regulation.<sup>71</sup> The CFTC understands that, by its terms, Section 15(a) does not require the CFTC to quantify the costs and benefits of a new regulation or to determine whether the benefits of the proposed regulation outweigh its costs. Nor does it require that each proposed rule be analyzed in isolation when that rule is a component of a larger package of rules or rule revisions. Rather, Section 15(a) simply requires the CFTC to "consider the costs and benefits" of its action.

Section 15(a) further specifies that costs and benefits shall be evaluated in light of five broad areas of market and public concern: protection of market participants and the public; efficiency, competitiveness, and financial integrity of futures markets; price discovery; sound risk management practices; and other public interest considerations. Accordingly, the CFTC could in its discretion give greater weight to any one of the five enumerated areas of concern and could in its discretion determine that, notwithstanding its costs, a particular rule was necessary or appropriate to protect the public interest or to effectuate any of the provisions or to accomplish any of the purposes of the Act.

The proposed rules constitute a package of related rule provisions. The rules provide guidance to trading facilities in order to facilitate compliance with governing laws. Furthermore, the rules provide alternatives that may reduce the costs of compliance.

<sup>71</sup> Section 15(a) of the CEA, 7 U.S.C. 19(a).

<sup>66</sup> Notice-registered national securities exchanges are those entities that register in accordance with Section 6(g) of the Exchange Act and proposed Rule 6a-4 under the Exchange Act by filing a proposed Form 1-N. See Securities Exchange Act Release No. 44279 (May 8, 2001).

<sup>67</sup> 17 CFR 240.17a-1.

<sup>68</sup> See Rule 17a-1 under the Exchange Act, 17 CFR 240.17a-1, and Sections 5(d)(17) and 5a(d)(8) of the CEA.

<sup>69</sup> 17 CFR 240.17a-1.

<sup>70</sup> See 63 FR 38865 (July 20, 1998) (SEC File No. 270-244, OMB Control No. 3235-0208) (seeking an extension of OMB approval of Rule 17a-1 under the Exchange Act).

The CFTC is considering the costs and benefits of the proposed rules as a totality, in light of the specific areas of concern identified in Section 15(a). The proposed rules should have no effect, from the standpoint of imposing costs or creating benefits, on the financial integrity or price discovery function of the futures and options markets or on the risk management practices of trading facilities or others. The proposed rules also should have no material effect on the protection of market participants and the public and should not impact the efficiency and competition of the markets.

Accordingly, the CFTC has determined to propose the rules discussed above. The CFTC invites public comment on the application of the cost-benefit provision of Section 15(a) of the CEA in regard to the proposed rules. Commenters also are invited to submit any data that they may have quantifying the costs and benefits of the proposed rules.

## SEC

The SEC is proposing new rules, Rules 3a55-1 through 3a55-3, under the Exchange Act. The proposed rules are in response to the mandate of the CFMA, which, among other things, requires the CFTC and SEC to jointly specify by rule or regulation the method to be used to determine "market capitalization" and "dollar value of average daily trading volume" with respect to implementing the new provisions of the CEA and Exchange Act regarding contracts for future delivery on security indexes.

The CFMA lifted the ban on, and will permit the trading of, single stock futures and futures on narrow-based security indexes. In addition to repealing the prohibition on certain types of security index futures, the CFMA amended the CEA and Exchange Act by adding the definition of "narrow-based security index." This definition establishes an objective test of whether a security index is narrow-based.<sup>72</sup> Futures contracts on security indexes that are narrow-based security indexes will be jointly regulated by the CFTC and the SEC under the framework established by the CFMA. Futures contracts on indexes that are not narrow-based security indexes, on the other hand, will be under the sole jurisdiction of the CFTC, and therefore only a designated contract market, registered derivatives transaction execution facility ("DTEF"), or foreign board of trade may trade these products.

Proposed Rule 3a55-1 under the Exchange Act would provide methods of calculating market capitalization and dollar value of average daily trading volume ("ADTV") for purposes of determining whether a security index is narrow-based within the meaning of the Exchange Act. Proposed Rule 3a55-2 under the Exchange Act would exempt from the definition of narrow-based security index those security indexes on which futures contracts have traded on a designated contract market, a registered DTEF, or foreign board of trade for fewer than 30 days, provided they would not have been narrow-based security indexes for an uninterrupted 6 full calendar months prior to the first day of trading. Proposed Rule 3a55-3 under the Exchange Act would establish that when a futures contract on a security index is traded on or subject to the rules of a foreign board of trade, that index shall not be considered a narrow-based security index if it would not be a narrow-based security index pursuant to the statutory definition of a narrow-based index or the exclusions from that definition. These proposed rules would provide methods of calculation and guidance for national securities exchanges, designated contract markets, registered DTEFs, and foreign boards of trade in determining whether or not a security index is narrow-based under the Exchange Act.

The SEC has identified below certain costs and benefits relating to proposed Rules 3a55-1 through 3a55-3 under the Exchange Act. The SEC requests comments on all aspects of this cost-benefit analysis, including identification of any additional costs and/or benefits of the proposed rules. The SEC encourages commenters to identify and supply any relevant data, analysis and estimates concerning the costs and/or benefits of the proposed rules.

### A. Benefits

The benefits of proposed Rules 3a55-1 through 3a55-3 under the Exchange Act are related to the benefits that will accrue as a result of the enactment of the CFMA. By repealing the ban on single stock futures and futures on narrow-based security indexes, the CFMA will enable a greater variety of financial products to be traded that potentially could facilitate price discovery and the ability to hedge. Investors will benefit by having a wider choice of financial products to buy and sell, and markets and market participants will benefit by having the ability to trade these products. The benefits are likely to relate to the volume of trading in these new instruments. Because security futures

are a new product, however, the SEC is unable to quantify these benefits and therefore requests comments, data, and estimates.

Furthermore, the CFMA clarifies the jurisdiction of the CFTC and the SEC over futures contracts on security indexes, and alleviates the regulatory burden of dual CFTC and SEC jurisdiction where it is appropriate to do so. Under the new provisions of the CEA and Exchange Act, the CFTC and SEC will jointly regulate futures contracts on narrow-based security indexes. The trading of futures contracts on broad-based security indexes will be under the sole jurisdiction of the CFTC and may be traded only on designated contract markets and by and through intermediaries registered with the CFTC. The CFMA provides objective criteria for determining whether or not a security index is narrow-based, and the proposed rules would provide instruction in applying those criteria. The SEC requests comments, data, and estimates regarding the increased regulatory certainty that will result from the definition of narrow-based security index contained in the Exchange Act.

Proposed Rule 3a55-1 under the Exchange Act would provide methodologies for determining market capitalization and the dollar value of ADTV for purposes of ascertaining whether or not a security index is narrow-based as defined in the CFMA. The proposed rules would provide the benefit of clear, objective standards for determining both market capitalization and the dollar value of ADTV. Market capitalization would, under the proposed rules, be computed as the product of the average price of a component security and the number of outstanding shares of that security. The dollar value of ADTV would, under the proposed rules, be computed as the product of the average price of a component security and the ADTV of that security.

To implement these calculations, the proposed rules would define "average daily trading volume" and, as more fully described below, a method to calculate "average price." In addition, the proposed rules would clarify how to calculate the dollar value of ADTV for the lowest weighted 25% of an index. The SEC requests specific comments regarding the benefits and efficiency of the proposed methods for determining market capitalization and the dollar value of ADTV, and invites comments regarding the benefits of any alternative approaches.

Proposed Rule 3a55-1 under the Exchange Act would provide the following objective definition for

<sup>72</sup> See Section 1a(25) of the CEA and Section 3(a)(55) of the Exchange Act.

“average price” for purposes of calculating market capitalization and dollar value of ADTV: The total dollar value of all transactions in a component security on the trading days of the principal market for the security during the preceding 6 full calendar months divided by the total number of shares traded in such transactions on the preceding 6 full calendar months, where the dollar value for each transaction is the price per share in U.S. dollars of that transaction multiplied by the number of shares in such transaction (“volume-weighted average price”).

For purposes of determining whether the dollar value of the ADTV of the lowest weighted 25% of an index reaches the statutory threshold of \$50 million (or \$30 million), the proposed rules would also permit a national securities exchange, designated contract market, registered DTEF, or foreign board of trade to elect a different method of calculation of average price, under certain conditions,<sup>73</sup> which may be more cost-efficient for it to use. Average price according to this method would be the sum of the price per share in U.S. dollars for each transaction in a component security during the preceding 6 full calendar months divided by the total number of such transactions during the preceding 6 full calendar months (“non-volume-weighted average price”). This choice provides flexibility in a manner that may lower implementation costs. The SEC seeks comments as to the benefits and flexibility of these two methods of calculating “average price” for purposes of determining whether the dollar value of ADTV of the lowest weighted 25% of an index meets the statutory threshold under the above-stated condition.

Proposed Rule 3a55-1 under the Exchange Act would also mandate a “snapshot” method for determining dollar value of ADTV for the lowest weighted 25% of an index.<sup>74</sup> On a particular day, the lowest weighted component securities comprising, in the aggregate, 25% of an index’s weighting, would be those securities that are the lowest weighted securities when all the securities in such index are ranked from

lowest to highest based on the index’s weighting methodology, and for which the sum of the weight of such securities is equal to, or less than, 25%.

The SEC believes that taking a “snapshot” of the securities comprising the lowest weighted 25% of an index for a particular day, and then using that “snapshot” to determine the dollar value of ADTV for those securities for the preceding 6 months, is a reasonable method of calculation that may reduce the computation burden on national securities exchanges, designated contract markets, registered DTEFs, and foreign boards of trade. Otherwise, for each day of the preceding 6 full calendar months, the market would have to assess the weighting of each security, rank the securities by weighting, and then determine the ADTV for the lowest weighted 25% of the index that day. The SEC seeks comments as to the benefits of this “snapshot” method of calculating the lowest weighted 25% of an index.

Under the Exchange Act, market capitalization and the dollar value of ADTV must be calculated “as of the preceding 6 full calendar months.” The proposed rule would specify a “rolling” 6 month period, *i.e.*, with respect to a particular day, the “preceding 6 full calendar months” would mean the period of time beginning on the same calendar date 6 months before and ending on the day prior to that day. A national securities exchange, designated contract market, registered DTEF, or foreign board of trade would benefit from this definition because a specific and objective time frame for the required calculations would be provided. The SEC requests comment as to the benefits of this “preceding 6 full calendar months” criteria and asks for suggestions and examples of any alternative approach.

The SEC believes proposed Rule 3a55-1 under the Exchange Act would provide an additional benefit to national securities exchanges, designated contract markets, registered DTEFs, and foreign boards of trade by permitting use of foreign trading data for the calculations of market capitalization and the dollar value of ADTV when component securities of an index are also traded on markets outside of the United States. The proposed rule would clarify that such foreign transaction data may be used only if it has been reported to a foreign financial regulatory authority in the jurisdiction in which the security is traded, and that, if the price information is reported in a foreign currency, it must be converted into U.S. dollars on the basis of the transaction date’s noon buying rate in

New York City for cable transfers in foreign currencies as certified for customs purposes by the Federal Reserve Bank of New York. The SEC invites comments and appropriate data regarding the benefits and/or costs associated with the use of information from transactions outside the United States.

In addition, proposed Rule 3a55-2 under the Exchange Act would provide a limited exclusion from the definition of “narrow-based security index” for an index underlying a futures contract that has traded for less than 30 days, as long as the index would not have been a narrow-based index for the 6 full calendar months prior to the first day of trading. This exclusion would be beneficial because it would allow futures contracts to continue to trade during this 30 day period without triggering Exchange Act provisions requiring registration by the market trading the futures. The SEC requests comments on the benefits of this exemption.

Finally, proposed Rule 3a55-3 under the Exchange Act would establish that when a futures contract on a security index is traded on or subject to the rules of a foreign board of trade, that index shall not be considered a narrow-based security index if it would not be a narrow-based security index pursuant to the statutory definition of a narrow-based security index or the exclusions from that definition. The proposed rule would clarify and establish that when a futures contract on an index is traded on or subject to the rules of a foreign board of trade, such index would not be a narrow-based security index if it would not be a narrow-based security index if a futures contract on such index were traded on a designated contract market or registered DTEF. The SEC seeks comments on the benefits of such a rule.

The SEC welcomes comments as to the benefits and flexibility provided by the methods of calculation and limited exclusion discussed above and also seeks comments as to any alternative methodologies that may be used.

#### B. Costs

In complying with proposed Rules 3a55-1 through 3a55-3 under the Exchange Act, a national securities exchange, designated contract market, registered DTEF, or foreign board of trade would incur certain costs. Under the CFMA, national securities exchanges, designated contract markets, registered DTEFs, and foreign boards of trade must use the methods provided by the proposed rules to determine whether or not a security index is narrow-based and thus whether the

<sup>73</sup> The proposed rules specify that the volume-weighted average price must be used for purposes of determining dollar value of ADTV of the lowest weighted 25% of an index, if the result is less than \$55,000,000 when using the non-volume-weighted average price (\$33,000,000 in the case of an index with 15 or more component securities).

<sup>74</sup> For purposes of the Exchange Act, a narrow-based security index includes an index in which the lowest weighted component securities comprising in the aggregate 25% of the index’s weighting have an aggregate dollar value of ADTV of less than \$50,000,000 (\$30,000,000 in the case of an index with 15 or more component securities).

futures contract is subject solely to the CFTC's jurisdiction or subject to joint jurisdiction of the CFTC and SEC. Thus the costs of complying with the proposed rules primarily are attributable to the implementation of the new provisions of the Exchange Act pertaining to the definition of narrow-based security index. National securities exchanges, designated contract markets, registered DTEFs, and foreign boards of trade trading these products are responsible for assuring compliance with the proposed rules and thus would incur various costs in determining the market capitalization and the dollar value of ADTV for component securities of a security index. The SEC, however, is unable at this time to estimate the extent of the costs the proposed calculation methodologies will engender.

The statutorily-mandated computations contained in the proposed rules would require national securities exchanges, designated contract markets, registered DTEFs, and foreign boards of trade to gather information to ascertain the market capitalization and the dollar value of ADTV for component securities of an index with respect to each day, taking into account data for the preceding 6 full calendar months. To compute market capitalization, the proposed rules require a market to know the number of outstanding shares of a security as reported on the issuer's most recent annual or periodic report filed with the SEC and each security's average price during the preceding 6 full calendar months. To compute dollar value of ADTV, the rules require a market to tally the average daily trading volume and the average price for each component security during the preceding 6 full calendar months. An additional calculation would be required to determine the lowest weighted 25% of an index. Alternatively, a market could incur costs if it contracted with an outside party to perform the calculations. In addition, a national securities exchange, designated contract market, registered DTEF, or foreign board of trade may be confronted with costs associated with obtaining and accessing appropriate data from an independent third party vendor. For example, national securities exchanges, designated contract markets, registered DTEFs, and foreign boards of trade may be required to pay certain fees to such a vendor to acquire the necessary information. Furthermore, if the market capitalization and dollar value of ADTV calculations require data that is not readily available, particularly if foreign data is used, national

securities exchanges, designated contract markets, registered DTEFs, and foreign boards of trade possibly would incur additional costs to obtain such data. The SEC requests comments, data, and estimates on all aspects of the costs associated with the proposed calculations. Commenters should address the likelihood that certain market information may not be readily available and the potential costs associated with obtaining that information.

In addition, an exclusion from the definition of narrow-based security index is available when all component securities are among both the Top 750 securities (by market capitalization) and Top 675 securities (by dollar value of ADTV). A designated contract market, registered DTEF, or foreign board of trade would be charged with identifying these Top 750 and Top 675 securities to determine whether a security index qualifies for this exclusion by using the calculations specified in the proposed rules. Commenters are requested to provide comments, cost estimates, and any other relevant data with respect to the costs involved in making such determinations.

The calculations required under the proposed rules for market capitalization and the dollar value of ADTV may require additional data storage.<sup>75</sup> A national securities exchange, designated contract market, or registered DTEF would need to consider how to store the data—whether to maintain hard copies or electronic copies of all the computations. The national securities exchange, designated contract market, or registered DTEF would also have to take into consideration the time period for which the data would have to be stored and the costs associated with such storage and maintenance. The SEC specifically requests comments on the recordkeeping costs and data maintenance associated with the proposals and whether these costs would be significant.

A national securities exchange, designated contract market, registered DTEF, or foreign board of trade may also incur resource costs to carry out the computations required under the proposed rules. Comments are requested as to whether the proposed rules are likely to result in a need to increase the number of staff, or result in additional

<sup>75</sup> Under Rule 17a-1 under the Exchange Act, 17 CFR 240.17a-1, and Sections 5(d)(17) and 5a(d)(8) of the CEA, and proposed Rule 41.2 under the CEA, respectively, national securities exchanges, designated contract markets, and registered DTEFs would need to preserve records of all their determinations with respect to the narrow-based or non-narrow-based status of security indexes.

resource burdens, to perform the required calculations. Commenters should provide cost data to support their views.

Finally, the SEC requests commenters to identify any other costs associated with the proposals that have not been considered herein, and what the extent of those costs would be.

### VIII. Consideration of Burden on Competition, and Promotion of Efficiency, Competition, and Capital Formation

#### SEC

Section 3(f) of the Exchange Act requires the SEC, when engaged in rulemaking that requires it to consider or determine whether an action is necessary or appropriate in the public interest, to consider whether the action would promote efficiency, competition, and capital formation.<sup>76</sup> Section 23(a)(2) requires the SEC, in adopting rules under the Exchange Act, to consider the impact any rule would have on competition.<sup>77</sup>

The SEC believes that proposed Rule 3a55-1 would promote efficiency by setting forth clear methods and guidelines for national securities exchanges, designated contract markets, registered DTEFs, and foreign boards of trade in applying the statutory definition of narrow-based security index. The SEC further believes that proposed Rule 3a55-2 would promote efficiency by providing designated contract markets, registered DTEFs, and foreign boards of trade a way to ensure that a futures contract trading solely under the jurisdiction of the CFTC does not suddenly become a security future within the first 30 days of trading and subject, as a result, to a new regulatory regime. The SEC also believes that proposed Rule 3a55-3 would promote efficiency by clarifying and establishing that when a futures contract on an index is traded on or subject to the rules of a foreign board of trade, such index would not be a narrow-based security index if it would not be a narrow-based security index if a futures contract on such index were traded on a designated contract market or registered DTEF.

The SEC preliminarily believes that the proposed rules may enhance capital formation, because the proposed rules would provide clarity with respect to the method for determining whether a particular security index is narrow-based or broad-based. In this way, market participants would have

<sup>76</sup> Section 3(f) of the Exchange Act, 15 U.S.C. 78c(f).

<sup>77</sup> Section 23(a)(2) of the Exchange Act, 15 U.S.C. 78w(a)(2).



certainty as to whether a futures contract on a particular index falls within the sole jurisdiction of the CFTC or will be under the joint jurisdiction of the SEC and CFTC. The benefits to the capital formation process, however, principally flow from the CFMA itself, which lifts the ban on the trading of single stock futures and narrow-based stock index futures.

The SEC preliminarily believes that the proposed rules would not impose any significant burdens on competition. The statutory definition of narrow-based security index and the exclusions from that definition contained in Section 1a(25)(A) and (B) of the CEA and Section 3(a)(55)(B) and (C) of the Exchange Act set forth the criteria that a market trading a futures contract on a stock index must use to determine whether the SEC and CFTC jointly, or the CFTC alone, would have regulatory authority over that futures contract. The statutory definition of a narrow-based security index and the exclusions from that definition substantively are identical in both the CEA and the Exchange Act, and the joint CFTC-SEC rules proposed in this release also are substantively identical.

The CFMA directs the SEC and CFTC to jointly specify methods for determining market capitalization and the dollar value of ADTV as those terms are used in the aforementioned statutory definition and exclusion. The SEC believes that proposed Rule 3a55-1, developed jointly with the CFTC, sets forth objective methods in fulfillment of the CFMA directive and further clarifies the application of the statute. The SEC believes that proposed Rule 3a55-2 is necessary in the public interest to prevent potential dislocations for market participants trading a futures contract on an index that becomes narrow-based during the first 30 days of trading and would impose no burden on competition. In addition, the SEC believes that proposed Rule 3a55-3 is necessary in the public interest and would impose no burden on competition because it serves to clarify and establish that when a futures contract on a security index is traded on or subject to the rules of a foreign board of trade, that index shall not be considered a narrow-based security index if it would not be a narrow-based security index pursuant to the statutory definition of a narrow-based security index or the exclusions from that definition.

The SEC requests comments on the potential benefits, as well as adverse consequences, that may result with respect to efficiency, competition, and

capital formation if the proposed rules are adopted.

## IX. Regulatory Flexibility Act Certifications

### CFTC

The Regulatory Flexibility Act ("RFA") requires federal agencies, in promulgating rules, to consider the impact of those rules on small entities.<sup>78</sup> The rules adopted herein would affect contract markets and other trading facilities. The CFTC has previously established certain definitions of "small entities" to be used in evaluating the impact of its rules on small entities in accordance with the RFA.<sup>79</sup> In its previous determinations, the CFTC has concluded that contract markets are not small entities for the purpose of the RFA.<sup>80</sup> The CFTC has also recently proposed determining that the other trading facilities subject to its jurisdiction, for reasons similar to those applicable to contract markets, would not be small entities for purposes of the RFA.<sup>81</sup>

Accordingly, the CFTC does not expect the rules, as proposed herein, to have a significant economic impact on a substantial number of small entities. Therefore, the Acting Chairman, on behalf of the CFTC, hereby certifies, pursuant to 5 U.S.C. 605(b), that the proposed amendments will not have a significant economic impact on a substantial number of small entities. The CFTC invites the public to comment on this finding and on its proposed determination that trading facilities such as registered DTEFs not be small entities for purposes of the RFA.

### SEC

Section 603(a)<sup>82</sup> of the Administrative Procedures Act ("APA"),<sup>83</sup> as amended by the RFA,<sup>84</sup> generally requires the SEC to undertake a regulatory flexibility analysis of all proposed rules, or proposed rule amendments, to determine the impact of such rulemaking on "small entities."<sup>85</sup>

<sup>78</sup> 5 U.S.C. 601 *et seq.*

<sup>79</sup> See 47 FR 18618-21 (April 30, 1982).

<sup>80</sup> See *id.* at 18619 (discussing contract markets).

<sup>81</sup> See 66 FR 14262, 14268 (March 9, 2001).

<sup>82</sup> 5 U.S.C. 603(a).

<sup>83</sup> 5 U.S.C. 551 *et seq.*

<sup>84</sup> 5 U.S.C. 601 *et seq.*

<sup>85</sup> Although Section 601(b) of the RFA defines the term "small entity," the statute permits agencies to formulate their own definitions. The Commission has adopted definitions of the term small entity for the purposes of Commission rulemaking in accordance with the RFA. Those definitions, as relevant to this proposed rulemaking, are set forth in Rule 0-10, 17 CFR 240.0-10. See Securities Exchange Act Release No. 18452 (January 28, 1982), 47 FR 5215 (February 4, 1982).

Section 605(b) of the RFA specifically exempts from this requirement any proposed rule, or proposed rule amendment, which, if adopted, would not "have a significant economic impact on a substantial number of small entities." Proposed Rule 3a55-1 provides methods for determining market capitalization and dollar value of ADTV in addition to other guidelines in applying the definition of narrow-based security index. Proposed Rule 3a55-2 creates an exemption from the definition of narrow-based security index for designated contract markets, registered DTEFs, and foreign boards of trade trading certain futures contracts. Proposed Rule 3a55-3 under the Exchange Act establishes that when a futures contract on a security index is traded on or subject to the rules of a foreign board of trade, that index shall not be considered a narrow-based security index if it would not be a narrow-based security index pursuant to the statutory definition of a narrow-based security index or the exclusions from that definition. Because only national securities exchanges, designated contract markets, registered DTEFs, and foreign boards of trade would be making determinations as to the status of security indexes on which future contracts are trading, the Acting Chairman of the SEC has certified that the proposed rules, if adopted, would not have a significant economic impact on a substantial number of small entities.

The SEC invites commenters to address whether the proposed rules would have a significant economic impact on a substantial number of small entities, and if so, what would be the nature of any impact on small entities. The SEC requests that commenters provide empirical data to support the extent of such impact.

This certification is attached as an Appendix.

## X. Statutory Bases and Text of Proposed Rules

### List of Subjects

#### 17 CFR Part 41

Security futures products, Reporting and recordkeeping requirements.

#### 17 CFR Part 240

Securities.

### Commodity Futures Trading Commission

#### 17 CFR Chapter I

In accordance with the foregoing, Title 17, chapter I of the Code of Federal Regulations is proposed to be amended by adding part 41 as follows:

## PART 41—SECURITY INDEX AND SECURITY FUTURES PRODUCTS

Sec.

### Subpart A—General Provisions

- 41.1 Definitions.  
41.2 Required records.  
41.3–41.9 [Reserved]

### Subpart B—Narrow-Based Security Indexes

- 41.10 Purpose and scope.  
41.11 Method for determining market capitalization and dollar value of average daily trading volume; application of the definition of narrow-based security index.  
41.12 Indexes underlying futures contracts trading for fewer than 30 days.  
41.13 Futures contracts on security indexes trading on or subject to the rules of a foreign board of trade.  
41.14 Transition period for indexes that cease being narrow-based security indexes.

**Authority:** 7 U.S.C. 1a(25), 2a and 12a(5).

### Subpart A—General Provisions

#### § 41.1 Definitions.

For purposes of this part:

(a) *Broad-based security index* means a group or index of securities that does not constitute a narrow-based security index.

(b) *Foreign board of trade* means a board of trade located outside of the United States, its territories or possessions, whether incorporated or unincorporated, where foreign futures or foreign options are entered into.

(c) *Narrow-based security index* has the same meaning as in section 1a(25) of the Commodity Exchange Act.

#### § 41.2 Required records.

A designated contract market or registered derivatives transaction execution facility that trades a security index or security futures product shall maintain in accordance with the requirements of § 1.31 books and records of all activities related to the trading of such products, including: Records related to any determination under subpart B of this part whether or not a futures contract on a security index is a narrow-based security index or a broad-based security index.

#### §§ 41.3–41.9 [Reserved]

### Subpart B—Narrow-Based Security Indexes

#### § 41.10 Purpose and scope.

This subpart includes methods to be used by trading facilities for the purpose of determining whether a futures product is based on an index of securities subject to the joint jurisdiction of the Commodity Futures

Trading Commission and the Securities and Exchange Commission or is based on a broad-based security index subject to the exclusive jurisdiction of the Commodity Futures Trading Commission. The methods included in this subpart relate to determining market capitalization and dollar value of average daily trading volume which are terms used, but not developed, in the statutory definitions of “narrow-based security product.” Consistent with Section 1a(25)(E)(ii) of the Commodity Exchange Act and Section 3a(55)(F)(ii) of the Securities Exchange Act of 1934, the methods for determining market capitalization and dollar value of average daily trading volume set forth in this subpart have been adopted jointly by the Commodity Futures Trading Commission and the Securities and Exchange Commission. The subpart also includes rules that permit, subject to certain conditions, a trading facility to continue to trade a narrow-based security index or a broad-based security index, as the case may be, after that index has become a broad-based security index or a narrow-based security index, as the case may be. The comparable rules of the Securities and Exchange Commission may be found at 17 CFR 240.3a55–1 through 240.3a55–3.

#### § 41.11 Method for determining market capitalization and dollar value of average daily trading volume; application of the definition of narrow-based security index.

(a) *Determining market capitalization and dollar value of average daily trading volume (“ADTV”).* The method to be used to determine a security’s market capitalization for purposes of Section 1a(25)(B) of the Act (7 U.S.C. 1a(25)(B)), and dollar value of ADTV for purposes of Section 1a(25)(A) and (B) of the Act (7 U.S.C. 1a(25)(A) and (B)) shall be as follows:

(1) *Market capitalization.* The market capitalization of a security is the product of:

(i) The average price of such security; and

(ii) The number of outstanding shares of such security.

(2) *Dollar value of ADTV.* (i) The dollar value of ADTV of a single security is the product of:

(A) The average price of such security; and

(B) The ADTV of such security.

(ii) The dollar value of ADTV of the lowest weighted 25% of an index is the sum of the dollar value of ADTV of each of the component securities comprising the lowest weighted 25% of such index.

(iii) The dollar value of ADTV of the lowest weighted 25% of an index may be calculated by using average price as

defined in paragraph (b)(2)(ii) of this section, provided that when such average price is used, the dollar value of ADTV of the lowest weighted 25% of the index equals or exceeds \$55,000,000 (or in the case of an index with 15 or more component securities, \$33,000,000).

(b) *Definitions.* For purposes of this section:

(1) *Average daily trading volume* in a security means the total number of shares of such security traded on the trading days of the principal market for the security during the preceding 6 full calendar months (which may include any shares traded on a market outside the United States, provided such information has been reported to a foreign financial regulatory authority in the jurisdiction where the security is traded) divided by the number of trading days of the principal market for the security during the preceding 6 full calendar months.

(2) *Average price.* (i) Average price of a security means the total dollar value of all transactions in such security on the trading days of the principal market for the security during the preceding 6 full calendar months (which may include transactions on a market outside the United States, provided such information has been reported to a foreign financial regulatory authority in the jurisdiction where the security is traded) divided by the total number of shares traded in such transactions, where the dollar value for each transaction is the price per share in U.S. dollars of such transaction multiplied by the number of shares in such transaction.

(ii) For purposes of paragraph (a)(2)(iii) of this section only, average price of a security may be calculated as the sum of the price per share in U.S. dollars for each transaction in such security on the trading days of the principal market for the security during the preceding 6 full calendar months (which may include prices of transactions on a market outside the United States, provided such information has been reported to a foreign financial regulatory authority in the jurisdiction where the security is traded) divided by the total number of such transactions during the preceding 6 full calendar months.

(iii) If the price of a transaction is reported in a currency other than U.S. dollars, such price must be converted into U.S. dollars on the basis of the transaction date’s noon buying rate in New York City for cable transfers in foreign currencies as certified for customs purposes by the Federal Reserve Bank of New York.

(iv) The transactions used to determine average price must be the same transactions used to determine ADTV.

(3) *Foreign financial regulatory authority* has the same meaning as in Section 3(a)(52) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(52)).

(4) *Lowest weighted 25% of an index*. With respect to any particular day, the lowest weighted component securities comprising, in the aggregate, 25% of an index's weighting for purposes of Section 1a(25) of the Act ("lowest weighted 25% of an index"), means those securities:

(i) That are the lowest weighted securities when all the securities in such index are ranked from lowest to highest based on the index's weighting methodology; and

(ii) For which the sum of the weight of such securities is equal to, or less than, 25%.

(5) *Outstanding shares of a security* means the number of outstanding shares of such security as reported on the most recent Form 10-K, Form 10-Q, Form 10-KSB, Form 10-QSB, or Form 20-F (17 CFR §§ 249.310, 249.308a, 249.310b, 249.308b, or 249.220f) filed with the Securities and Exchange Commission by the issuer of such security.

(6) *Preceding 6 full calendar months* means, with respect to a particular day, the period of time beginning on the same day of the month 6 months before and ending on the day prior to such day.

(7) *Principal market* for a security means the single securities market with the largest reported trading volume for the security during the preceding 6 full calendar months.

(8) *Trading days of the principal market* means all days on which the principal market for the security is open for trading.

(9) *Weighting of a component security of an index* means the percentage of such index's value represented, or accounted for, by such component security.

#### **§ 41.12 Indexes underlying futures contracts trading for fewer than 30 days.**

(a) An index on which a contract of sale for future delivery is trading on a designated contract market, registered derivatives transaction execution facility, or foreign board of trade is not a narrow-based security index under Section 1a(25) of the Act (7 U.S.C. 1a(25)) for the first 30 days of trading, if 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.

(b) An index that is not a narrow-based security index for the first 30 days of trading pursuant to paragraph (a) of this section, shall become a narrow-based security index if such index has been a narrow-based security index for more than 45 business days over 3 consecutive calendar months.

(c) An index that becomes a narrow-based security index solely because it was a narrow-based security index for more than 45 business days over 3 consecutive calendar months pursuant to paragraph (b) of this section shall not be a narrow-based security index for the following 3 calendar months.

(d) *Preceding 6 full calendar months* has the same meaning as in § 41.11(b)(6).

#### **§ 41.13 Futures contracts on security indexes trading on or subject to the rules of a foreign board of trade.**

When a contract of sale for future delivery on a security index is traded on or subject to the rules of a foreign board of trade, such index shall not be a narrow-based security index if a futures contract on such index were traded on a designated contract market or registered derivatives transaction execution facility.

#### **§ 41.14 Transition period for indexes that cease being narrow-based security indexes.**

(a) *Forty-five day tolerance provision*. An index that is a narrow-based security index that becomes a broad-based security index for no more than 45 days over 3 consecutive calendar months shall be a narrow-based security index.

(b) *Transition period for indexes that cease being narrow-based security indexes for more than forty-five days*. An index that is a narrow-based security index that becomes a broad-based security index for more than 45 days over 3 consecutive calendar months shall continue to be a narrow-based security index for the following 3 calendar months.

(c) *Trading in months with open interest following transition period*. After the transition period provided for in paragraph (b) of this section ends, a national securities exchange may continue to trade only in those months in the security futures product that had open interest on the date the transition period ended and shall limit trading to positions that liquidate previously-established positions.

(d) *Definition of calendar month*. Calendar month means, with respect to a particular day, the period of time beginning on a calendar date and ending during another month on a day prior to such date.

By the Commodity Futures Trading Commission.

Dated: May 10, 2001.

**Jean A. Webb,**  
*Secretary.*

### **Securities and Exchange Commission 17 CFR Chapter II**

In accordance with the foregoing, Title 17, chapter II, part 240 of the Code of Federal Regulations is proposed to be amended as follows:

#### **PART 240—GENERAL RULES AND REGULATIONS, SECURITIES EXCHANGE ACT OF 1934**

1. The authority citation for part 240 continues to read, in part, as follows:

**Authority:** 15 U.S.C. 77c, 77d, 77g, 77j, 77s, 77z-2, 77z-3, 77eee, 77ggg, 77nnn, 77sss, 77ttt, 78c, 78d, 78f, 78i, 78j, 78j-1, 78k, 78k-1, 78l, 78m, 78n, 78o, 78p, 78q, 78s, 78u-5, 78w, 78x, 78ll, 78mm, 79q, 79t, 80a-20, 80a-23, 80a-29, 80a-37, 80b-3, 80b-4 and 80b-11, unless otherwise noted.

\* \* \* \* \*

2. Sections 240.3a55-1 through 240.3a55-3 are added to read as follows:

#### **§ 240.3a55-1 Method for determining market capitalization and dollar value of average daily trading volume; application of the definition of narrow-based security index.**

(a) *Determining market capitalization and dollar value of average daily trading volume ("ADTV")*. The method to be used to determine a security's market capitalization for purposes of Section 3(a)(55)(C) of the Act (15 U.S.C. 78c(a)(55)(C)) and dollar value of ADTV for purposes of Section 3(a)(55)(B) and (C) of the Act (15 U.S.C. 78c(a)(55)(B) and (C)) shall be as follows:

(1) *Market capitalization*. The market capitalization of a security is the product of:

(i) The average price of such security; and

(ii) The number of outstanding shares of such security.

(2) *Dollar value of ADTV*. (i) The dollar value of ADTV of a single security is the product of:

(A) The average price of such security; and

(B) The ADTV of such security.

(ii) The dollar value of ADTV of the lowest weighted 25% of an index is the sum of the dollar value of ADTV of each of the component securities comprising the lowest weighted 25% of such index.

(iii) The dollar value of ADTV of the lowest weighted 25% of an index may be calculated by using average price as defined in paragraph (b)(2)(ii) of this section, provided that when such average price is used, the dollar value of ADTV of the lowest weighted 25% of

the index equals or exceeds \$55,000,000 (or in the case of an index with 15 or more component securities, \$33,000,000).

(b) *Definitions.* For purposes of this section:

(1) *Average daily trading volume* in a security means the total number of shares of such security traded on the trading days of the principal market for the security during the preceding 6 full calendar months (which may include any shares traded on a market outside the United States, provided such information has been reported to a foreign financial regulatory authority in the jurisdiction where the security is traded) divided by the number of trading days of the principal market for the security during the preceding 6 full calendar months.

(2) *Average price.* (i) Average price of a security means the total dollar value of all transactions in such security on the trading days of the principal market for the security during the preceding 6 full calendar months (which may include transactions on a market outside the United States, provided such information has been reported to a foreign financial regulatory authority in the jurisdiction where the security is traded) divided by the total number of shares traded in such transactions, where the dollar value for each transaction is the price per share in U.S. dollars of such transaction multiplied by the number of shares in such transaction.

(ii) For purposes of paragraph (a)(2)(iii) of this section only, average price of a security may be calculated as the sum of the price per share in U.S. dollars for each transaction in such security on the trading days of the principal market for the security during the preceding 6 full calendar months (which may include prices of transactions on a market outside the United States, provided such information has been reported to a foreign financial regulatory authority in the jurisdiction where the security is traded) divided by the total number of such transactions during the preceding 6 full calendar months.

(iii) If the price of a transaction is reported in a currency other than U.S. dollars, such price must be converted into U.S. dollars on the basis of the transaction date's noon buying rate in New York City for cable transfers in foreign currencies as certified for customs purposes by the Federal Reserve Bank of New York.

(iv) The transactions used to determine average price must be the same transactions used to determine ADTV.

(3) *Foreign financial regulatory authority* has the same meaning as in Section 3(a)(52) of the Act (15 U.S.C. 78c(a)(52)).

(4) *Lowest weighted 25% of an index.* With respect to any particular day, the lowest weighted component securities comprising, in the aggregate, 25% of an index's weighting for purposes of Section 3(a)(55)(B)(iv) of the Act (15 U.S.C. 78c(a)(55)(B)(iv)) ("lowest weighted 25% of an index") means those securities:

(i) That are the lowest weighted securities when all the securities in such index are ranked from lowest to highest based on the index's weighting methodology; and

(ii) For which the sum of the weight of such securities is equal to, or less than, 25%.

(5) *Outstanding shares* of a security means the number of outstanding shares of such security as reported on the most recent Form 10-K, Form 10-Q, Form 10-KSB, Form 10-QSB, or Form 20-F (17 CFR 249.310, 249.308a, 249.310b, 249.308b, or 249.220f) filed with the Commission by the issuer of such security.

(6) *Preceding 6 full calendar months* means, with respect to a particular day, the period of time beginning on the same day of the month 6 months before and ending on the day prior to such day.

(7) *Principal market* for a security means the single securities market with the largest reported trading volume for the security during the preceding 6 full calendar months.

(8) *Trading days* of the principal market means all days on which the principal market for the security is open for trading.

(9) *Weighting* of a component security of an index means the percentage of such index's value represented, or accounted for, by such component security.

**§ 240.3a55-2 Indexes underlying futures contracts trading for fewer than 30 days.**

(a) An index on which a contract of sale for future delivery is trading on a designated contract market, registered derivatives transaction execution facility, or foreign board of trade is not a narrow-based security index under Section 3(a)(55) of the Act (15 U.S.C. 78c(a)(55)) for the first 30 days of trading, if 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.

(b) An index that is not a narrow-based security index for the first 30 days of trading pursuant to paragraph (a) of

this section, shall become a narrow-based security index if such index has been a narrow-based security index for more than 45 business days over 3 consecutive calendar months.

(c) An index that becomes a narrow-based security index solely because it was a narrow-based security index for more than 45 business days over 3 consecutive calendar months pursuant to paragraph (b) of this section shall not be a narrow-based security index for the following 3 calendar months.

(d) *Preceding 6 full calendar months* has the same meaning as in § 240.3a55-1.

**§ 240.3a55-3 Futures contracts on security indexes trading on or subject to the rules of a foreign board of trade.**

When a contract of sale for future delivery on a security index is traded on or subject to the rules of a foreign board of trade, such index shall not be a narrow-based security index if it would not be a narrow-based security index if a futures contract on such index were traded on a designated contract market or registered derivatives transaction execution facility.

By the Securities and Exchange Commission.

Dated: May 10, 2001.

**Margaret H. McFarland,**  
*Deputy Secretary.*

**Appendix**

**Note:** This appendix to the preamble will not appear in the Code of Federal Regulations.

**Regulatory Flexibility Act Certification**

I, Laura S. Unger, Acting Chairman of the Securities and Exchange Commission ("SEC"), hereby certify, pursuant to 5 U.S.C. 605(b), that proposed Rules 3a55-1, 3a55-2, and 3a55-3 under the Securities Exchange Act of 1934 ("Exchange Act") would not, if adopted, have a significant economic impact on a substantial number of small entities. Under the Commodity Futures Modernization Act of 2000, the SEC and the Commodity Futures Trading Commission ("CFTC") jointly must specify the method to be used to determine "market capitalization" and "dollar value of average daily trading volume" ("ADTV") for purposes of Section 3(a)(55) of the Exchange Act and Section 1a(25) of the Commodity Exchange Act. Proposed Rule 3a55-1 would specify the methods for determining the dollar value of ADTV and market capitalization for purposes of ascertaining whether a security index is narrow-based under Section 3(a)(55) of the Exchange Act. Proposed Rule 3a55-2 would create an exemption from the definition of narrow-based security index for designated contract markets, registered derivatives transaction execution facilities ("DTEFs"), and foreign boards of trade trading certain futures contracts. Proposed Rule 3a55-3 under the Exchange Act would establish that

when a futures contract on a security index is traded on or subject to the rules of a foreign board of trade, that index shall not be considered a narrow-based security index if it would not be a narrow-based security index pursuant to the definition of a narrow-based security index, or the exclusions from that definition, contained in Section 3(a)(55) of the Exchange Act. The proposed rules

would be incorporated into a joint rulemaking with the CFTC. Only national securities exchanges, designated contract markets, registered DTEFs, and foreign boards of trade would be involved in the calculation of ADTV and market capitalization, all of which are not small entities for purposes of the Regulatory Flexibility Act. Accordingly, proposed Rules

3a55-1, 3a55-2, and 3a55-3 would not have a significant economic impact on a substantial number of small entities.

Dated: May 9, 2001.

Laura S. Unger,  
*Acting Chairman.*

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