

COMMODITY FUTURES TRADING COMMISSION

SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-61020]

Joint Order to Exclude Indexes Composed of Certain Index Options from the Definition of Narrow-Based Security Index Pursuant to Section 1a(25)(B)(vi) of the Commodity Exchange Act and Section 3(a)(55)(C)(vi) of the Securities Exchange Act of 1934

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

**ACTION:** Joint Order.

**SUMMARY:** The Commodity Futures Trading Commission (“CFTC”) and the Securities and Exchange Commission (“SEC”) (collectively, “Commissions”) by joint order under the Commodity Exchange Act (“CEA”) and the Securities Exchange Act of 1934 (“Exchange Act”) are excluding certain security indexes from the definition of “narrow-based security index.” Specifically, the Commissions are excluding from the definition of the term “narrow-based security index” certain volatility indexes composed of series of index options on broad-based security indexes.

**EFFECTIVE DATE:** November 17, 2009

**FOR FURTHER INFORMATION CONTACT:**

**CFTC:** Thomas M. Leahy, Jr., Branch Chief, Market and Product Review Section, Division of Market Oversight, telephone: (202) 418-5278 or Julian E. Hammar, Assistant General Counsel, telephone: (202) 418-5118, Commodity Futures Trading Commission, 1155 21st Street NW, Washington, DC 20581.

**SEC:** Richard R. Holley III, Senior Special Counsel, Division of Trading and Markets, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549. Telephone (202) 551-5614.

**SUPPLEMENTARY INFORMATION:**

**I. BACKGROUND**

Futures contracts on single securities and on narrow-based security indexes (collectively, “security futures”) are jointly regulated by the CFTC and the SEC.<sup>1</sup> To distinguish between security futures on narrow-based security indexes, which are jointly regulated by the Commissions, and futures contracts on broad-based security indexes, which are under the exclusive jurisdiction of the CFTC, the CEA and the Exchange Act each includes an objective definition of the term “narrow-based security index.” A futures contract on an index that meets the definition of a narrow-based security index is a security future. A futures contract on an index that does not meet the definition of a narrow-based security index is a futures contract on a broad-based security index.<sup>2</sup>

Section 1a(25)(A) of the CEA<sup>3</sup> and Section 3(a)(55)(B) of the Exchange Act<sup>4</sup> provide that an index is a “narrow-based security index” if, among other things, it meets one of the following four criteria:

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<sup>1</sup> See Section 1a(31) of the CEA and Section 3(a)(55)(A) of the Exchange Act, 7 U.S.C. 1a(31) and 15 U.S.C. 78c(a)(55)(A).

<sup>2</sup> See 17 CFR 41.1(c).

<sup>3</sup> 7 U.S.C. 1a(25)(A).

<sup>4</sup> 15 U.S.C. 78c(a)(55)(B).

- (i) the index has nine or fewer component securities;
- (ii) any component security of the index comprises more than 30 percent of the index's weighting;
- (iii) the five highest weighted component securities of the index in the aggregate comprise more than 60 percent of the index's weighting; or
- (iv) the lowest weighted component securities comprising, in the aggregate, 25 percent of the index's weighting have an aggregate dollar value of average daily trading volume of less than \$50,000,000 (or in the case of an index with 15 or more component securities, \$30,000,000), except that if there are two or more securities with equal weighting that could be included in the calculation of the lowest weighted component securities comprising, in the aggregate, 25 percent of the index's weighting, such securities shall be ranked from lowest to highest dollar value of average daily trading volume and shall be included in the calculation based on their ranking starting with the lowest ranked security.

The first three criteria evaluate the composition and weighting of the securities in the index. The fourth criterion evaluates the liquidity of an index's component securities.

Section 1a(25)(B)(vi) of the CEA<sup>5</sup> and Section 3(a)(55)(C)(vi) of the Exchange Act<sup>6</sup> provide that, notwithstanding the above criteria, an index is not a narrow-based security index if a contract of sale for future delivery on the index is traded on or subject to the rules of a board of trade and meets such requirements as are jointly established by rule, regulation, or order by the Commissions. Pursuant to that authority, the Commissions may jointly exclude an index from the definition of the term "narrow-based security index."

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<sup>5</sup> 7 U.S.C. 1a(25)(B)(vi).

<sup>6</sup> 15 U.S.C. 78c(a)(55)(C)(vi).

Using this authority, on March 25, 2004, the Commissions issued a joint order excluding volatility indexes that satisfy certain conditions from the definition of “narrow-based security index”.<sup>7</sup>

## II. DISCUSSION

The statutory definition of the term “narrow-based security index” is designed to distinguish among indexes composed of individual stocks. As a result, certain aspects of that definition are designed to take into account the trading patterns of individual stocks rather than those of other types of exchange-traded securities, such as security index options. However, the Commissions believe that the definition is not limited to indexes on individual stocks. In fact, Section 1a(25)(B)(vi) of the CEA<sup>8</sup> and Section 3(a)(55)(C)(vi) of the Exchange Act<sup>9</sup> give the Commissions joint authority to make determinations with respect to security indexes that do not meet the specific statutory criteria.

The Commissions believed, when issuing the 2004 Joint Order excluding certain volatility indexes from the definition of “narrow-based security index,” that certain volatility indexes were appropriately classified as broad-based because they measure the magnitude of changes in the level of an underlying index that is a broad-based security index. Further, the Commissions noted that they believed that futures contracts on volatility indexes that satisfied the conditions set forth in the 2004 Joint Order should not be readily susceptible to manipulation.

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<sup>7</sup> See Securities Exchange Act Release No. 49469 (March 25, 2004), 69 FR 16900 (March 31, 2004) (“2004 Joint Order”). Following the issuance of the 2004 Joint Order, the CBOE Futures Exchange, LLC listed for trading futures contracts on the CBOE Volatility Index (“VIX”).

<sup>8</sup> 7 U.S.C. 1a(25)(B)(vi).

<sup>9</sup> 15 U.S.C. 78c(a)(55)(C)(vi).

The Commissions believed that those conditions reduce the ability to manipulate the price of the futures contracts through manipulation of the options comprising the volatility index.

Eurex<sup>10</sup> has requested that the Commissions exclude the VDAX-NEW® volatility index from the definition of “narrow-based security index.”<sup>11</sup> According to Eurex, this volatility index meets all the conditions set forth in the 2004 Joint Order, except the sixth condition, which requires that “[o]ptions on the Underlying Broad-Based Security Index... [be] listed and traded on a national securities exchange registered under section 6(a) of the Exchange Act.”<sup>12</sup> The Commissions note that a volatility index based on index options traded on a foreign exchange, such as the VDAX-NEW®, would be unable to satisfy this condition.

In the 2004 Joint Order the Commissions stated, with respect to the sixth condition, that:

Given the novelty of volatility indexes, the Commissions believe at this time that it is appropriate to limit the component securities to those index options that are listed for trading on a national securities exchange where the Commissions know pricing information is current, accurate and publicly available.<sup>13</sup>

In response to Eurex’s request, the Commissions believe that certain volatility indexes should be excluded from the definition of “narrow-based security index” if the index options used to calculate the magnitude of change in the level of the underlying broad-based security index are listed for trading on an exchange and pricing information for the underlying broad-based security index, and options on such index, is computed and disseminated in real-time through major market data vendors. For purposes of this Order, the Commissions would consider such pricing information to be current, accurate, and publicly available.

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<sup>10</sup> Eurex Deutschland is operated by Eurex Frankfurt AG (hereinafter “Eurex Deutschland” and “Eurex Frankfurt AG” together are referred to as “Eurex”).

<sup>11</sup> See Letter from Paul M. Architzel, Alston & Bird, LLP, to Nancy Morris, Secretary, SEC, and Eileen Donovan, Acting Secretary, CFTC, dated December 18, 2006.

<sup>12</sup> See 2004 Joint Order, supra note 7, 69 FR at 16901.

<sup>13</sup> See id.

The Commissions believe that, when pricing information for the index underlying a volatility index and for the index options that compose the volatility index is current, accurate, and publicly available, it would minimize the ability to manipulate the index options used to calculate the volatility index. As a result, futures contracts on such a volatility index would not be readily susceptible to manipulation.

Therefore, the Commissions believe that an alternative to the sixth condition in the 2004 Joint Order, which requires that the component securities of a volatility index (i.e., options on the underlying broad-based index) be listed for trading on a national securities exchange registered pursuant to Exchange Act Section 6(a), would be appropriate in certain circumstances. The Commissions believe that it is appropriate to permit the component securities of a volatility index to be listed for trading on any exchange, provided that pricing information for the underlying broad-based security index, and the options on such index that compose the volatility index, is current, accurate, and publicly available. Specifically, the new sixth condition would require such pricing information to be computed and disseminated in real-time through major market data vendors.

In addition to the alternative sixth condition discussed above, a volatility index would have to satisfy the other conditions in the 2004 Joint Order, which are set forth below.<sup>14</sup> The Commissions also reaffirm the rationale for those conditions stated in the 2004 Joint Order.

Accordingly,

IT IS ORDERED, pursuant to Section 1a(25)(B)(vi) of the CEA and Section 3(a)(55)(C)(vi) of the Exchange Act, that an index is not a narrow-based security index and is therefore a broad-based security index, if:

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<sup>14</sup> The Commissions note that nothing in this joint order should be construed as repealing or otherwise revoking the 2004 Joint Order.

(1) The index measures the magnitude of changes in the level of an underlying broad-based security index that is not a narrow-based security index as that term is defined in Section 1a(25) of the CEA and Section 3(a)(55) of the Exchange Act over a defined period of time, which magnitude is calculated using the prices of options on the underlying broad-based security index and represents (a) an annualized standard deviation of percent changes in the level of the underlying broad-based security index, (b) an annualized variance of percent changes in the level of the underlying broad-based security index, or (c) on a non-annualized basis, either the standard deviation or the variance of percent changes in the level of the underlying broad-based security index;

(2) The volatility index has more than nine component securities, all of which are options on the underlying broad-based security index;

(3) No component security of the volatility index comprises more than 30% of the volatility index's weighting;

(4) The five highest weighted component securities of the volatility index in the aggregate do not comprise more than 60% of the volatility index's weighting;

(5) The average daily trading volume of the lowest weighted component securities in the underlying broad-based security index upon which the volatility index is calculated (those comprising, in the aggregate, 25% of the underlying broad-based security index's weighting) has a dollar value of more than \$50,000,000 (or \$30,000,000 in the case of an underlying broad-based security index with 15 or more component securities), except if there are two or more securities with equal weighting that could be included in the calculation of the lowest weighted component securities comprising, in the aggregate, 25% of the underlying broad-based security index's weighting, such securities shall be ranked from lowest to highest dollar value of average

daily trading volume and shall be included in the calculation based on their ranking starting with the lowest ranked security;

(6) The index options used to calculate the magnitude of change in the level of the underlying broad-based security index are listed for trading on an exchange and pricing information for the underlying broad-based security index, and options on such index, is computed and disseminated in real-time through major market data vendors; and

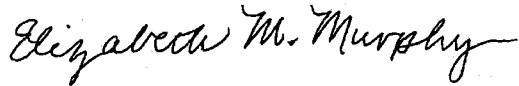
(7) The aggregate average daily trading volume in options on the underlying broad-based security index is at least 10,000 contracts calculated as of the preceding 6 full calendar months.

By the Commodity Futures Trading Commission.

David A. Stawick  
Secretary

November 17, 2009

By the Securities and Exchange Commission.



Elizabeth M. Murphy  
Secretary

November 17, 2009



**THIS SIGNATURE PAGE RELATES TO THE COMMODITY FUTURES TRADING COMMISSION'S PORTION OF THE JOINT ORDER TO EXCLUDE INDEXES COMPOSED OF CERTAIN INDEX OPTIONS FROM THE DEFINITION OF NARROW-BASED SECURITY INDEX PURSUANT TO SECTION 1a(25)(B)(vi) OF THE COMMODITY EXCHANGE ACT AND SECTION 3(a)(55)(C)(vi) OF THE SECURITIES EXCHANGE ACT OF 1934.**

By the Commodity Futures Trading Commission.

A handwritten signature in blue ink, reading "David A. Stawick". The signature is written in a cursive style with a horizontal line underneath the name.

David A. Stawick  
Secretary

November 17, 2009