



Securities Industry Association

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August 3, 2001

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

Jean A. Webb
Secretary
Commodity Futures Trading Commission
Three Lafayette Center
1155 21st Street, N.W.
Washington, DC 20581

Re: Narrow-Based Security Indexes
 SEC File No. S7-11-01

Dear Mr. Katz and Ms. Webb:

The Securities Industry Association (the “SIA”)¹ is submitting this comment letter in response to the joint release,² dated May 17, 2001, issued by the Securities and Exchange Commission (the “SEC”) and the Commodity Futures Trading Commission (the “CFTC”) proposing new Rules 3a55-1 through 3a55-3 under the Securities Exchange Act of 1934 and new Rule 41 under the Commodity Exchange Act (the “Proposed Rules”) relating to the definition of “narrow-based security index” under those statutes.

The SIA is pleased to have this opportunity to comment on the Proposed Rules and commends the SEC and CFTC for taking prompt action to elaborate and clarify the definition of “narrow-based security index.” This definition is significant in that it determines whether a stock index futures contract will be subject to regulation only under the Commodity Exchange Act (the “CEA”) or will be subject to the new dual regulatory structure for security

¹ The Securities Industry Association brings together the shared interests of more than 740 securities firms to accomplish common goals. SIA member firms (including investment banks, brokers-dealers, and mutual fund companies) are active in all U.S. and foreign markets and in all phases of corporate and public finance. The U.S. securities industry manages the accounts of more than 50 million investors directly and tens of millions of investors indirectly through corporate, thrift and pension plans. The industry generates more than \$300 billion of revenues yearly in the U.S. economy and employs more than 600,000 individuals. (More information about the SIA is available on its home page: <http://www.sia.com>.)

² *Method for Determining Market Capitalization and Dollar Value of Average Daily Trading Volume; Application of the Definition of Narrow-Based Security Index*, 66 Fed. Reg. 27560 (May 17, 2001).

futures under the CEA and the Securities Exchange Act of 1934 (the “Exchange Act”) created by the Commodity Futures Modernization Act of 2000 (the “CFMA”).

The SIA agrees with the SEC and CFTC (the “Agencies”) that the narrow-based security index definition must be “easily understood and applied by market participants,” and the SIA believes that the Proposed Rules represent an important step toward achieving that goal. The SIA nonetheless believes that the approach taken in the Proposed Rules is in certain respects unnecessarily burdensome and may lead to uncertainty as to whether stock index futures contracts will be viewed as broad-based or narrow-based on an ongoing basis. As discussed in more detail below, the SIA also urges the Agencies to establish alternative definitions in the context of foreign stock index futures contracts that involve stocks that are not primarily traded in the United States.

1. General Comments.

The SIA believes that any approach to the broad-based/narrow-based distinction should satisfy three criteria. First, the approach should be transparent—that is, the standard should be easily applied, and should be based on publicly available information or calculations easily derived from publicly available information. Second, the approach should not require unnecessarily repetitive, complex or burdensome calculations. Third, the approach should not lead to excessive potential “volatility” in the regulatory status of an index—that is, indices should not be subject to frequent changes in status between broad-based and narrow-based.

In the SIA’s view, the Proposed Rules could be improved in certain respects in light of these objectives. In particular, the approach set forth in the Proposed Rules, because of the number of calculations that are required to be made, the number of securities with respect to which those calculations are required to be made and the frequency with which those calculations must be made, will be potentially cumbersome and time-consuming for market participants. The data underlying these calculations may also be different from that commonly provided by data vendors and accordingly may be difficult to obtain. In addition, the Proposed Rules would create unnecessary uncertainty as to the status of a particular index, which could change from broad-based to narrow-based every six months with significant adverse consequences to the investment community that may be engaged in medium- or long-term strategies based on the availability of contracts on such indices. These uncertainties may inhibit the listing and trading of futures contracts on all but the broadest of stock indices and narrow-based indices that do not pose a risk of transition to broad-based status. For futures contracts on indices that are close to the line between broad-based and narrow-based, the risk that the contract could be recharacterized every six months would make it difficult for exchanges to justify the expense of developing such products. This result would be inconsistent with the goal embodied in the CFMA of facilitating the trading of stock index futures contracts.

2. General Recommendations.

The SIA believes that these problems could be mitigated by regulations that would require only an annual determination as to whether an index is narrow-based or broad-based. In addition, the SIA recommends that if, as of the next annual determination date, the

index has changed from broad-based to narrow-based or vice versa, a contract on the index should be permitted to continue trading for an additional one-year grace period.

The annual determination approach would have the operational advantage of not requiring frequent recalculation by the relevant exchange or market of the status of the underlying index. It would promote certainty for investors as to the characterization of the product they are acquiring. It will also assist intermediaries in determining the manner in which positions must be carried (i.e., a futures contract in a standard futures account, or as a security future under the appropriate regime to be established by the Agencies), and in complying with related regulatory requirements. Such an approach would limit the possibility that a stock index futures contract traded on a contract market or DTEF would become subject to regulation as a security future, with the accompanying additional requirements under the CEA and the Exchange Act applicable to both the exchange and intermediaries. It would also limit the risk that a security future traded on a national securities exchange or national securities association that is notice registered as a contract market will no longer be able to be traded on that market if the underlying index becomes broad-based. By reducing the risk of a short-term change in regulatory status of stock index futures contract, this approach will avoid the disruption for investors that such a change could otherwise cause and facilitate the trading of such contracts on each type of market.

This approach would also be consistent with the principal policy consideration behind the distinction between broad-based and narrow-based—whether a contract traded on the index is susceptible to being manipulated or used as a surrogate for trading the component stocks. To the extent a change in the index composition during the grace period would substantially increase the risk of manipulation or surrogate trading, there may be more narrowly targeted ways to address these concerns without requiring exchanges, intermediaries and other market participants to change the way the relevant contract is traded and carried. For example, the Agencies might consider permitting, on an exemptive basis, the contract to continue to be traded as a broad-based futures contract, while applying specific securities law provisions, such as the antifraud and antimanipulation provisions, to trading in the contract. The SIA stands ready to work with the Agencies and other relevant parties to develop protections against manipulation and surrogate trading without creating other adverse regulatory consequences in the case of contracts on indices that become narrow-based.

The SIA recognizes that this approach differs from the grace periods specified in the CFMA and proposed in the Proposed Rules and that the SEC and CFTC may need to promulgate additional exemptive and other rules as to the treatment of contracts during the grace period to fully implement this approach. Nonetheless, the SIA believes that the difference is principally a matter of degree and that this approach would be an appropriate use of the Agencies' exemptive authority that would facilitate the trading of both broad-based and narrow-based index futures.

3. Determination of the Top 750 and Top 675 Securities.

The exclusion from the definition of narrow-based security index in Section 3(a)(55)(C)(i) of the Exchange Act and Section 1a(25)(B)(i) of the CEA (the "Market Cap/ADTV Exclusion") requires, among other criteria, that each of the securities in the index be

in the top 750 securities by market capitalization and top 675 securities by dollar value of average daily trading volume (“Dollar ADTV”).

The SIA believes that it would be helpful for the Agencies to publish a list of the top 750 and top 675 securities on a periodic (such as a quarterly or monthly) basis for purposes of determining compliance with the Market Cap/ADTV Exclusion. This approach would provide certainty for market participants as to the stocks eligible to be included in an index that relies on the Market Cap/ADTV Exclusion. It would also significantly enhance the transparency of the distinction and eliminate the need for market participants to regularly reassess the Market Capitalization and Dollar ADTV of the top 750 and top 675 stocks.

4. Foreign Stock Index Futures Contracts.

The SIA welcomes the clarification by the Agencies that an index on which futures contracts are traded on a foreign board of trade would be treated as broad-based if it does not fall within the statutory definition of narrow-based securities index in Section 1a(25)(A) of the CEA and Section 3(a)(55)(B) of the Exchange Act (the “Statutory Narrow-Based Definition”).³ This position will permit the CFTC to continue its existing practice of allowing the offer and sale of broad-based foreign stock index futures contracts in the United States and to U.S. persons pursuant to staff no-action relief. The SIA believes, however, that it might be desirable for the CFTC to consider replacing its no-action approach with a certification process. Under such an approach, a broad-based index futures contract traded on a foreign exchange could be offered or sold in the United States or to U.S. persons if the foreign exchange certifies to the CFTC that the index is broad-based⁴ and the contract otherwise satisfies the requirements of Section 2(a)(1)(C)(ii) of the CEA.⁵ Such an approach would be particularly appropriate for foreign exchanges that have previously received no-action relief in connection with stock index futures contracts or that are the subject of a CFTC Rule 30.10 exemption.

Although the Proposed Rules would make available to foreign stock index futures contracts the Market Cap/ADTV Exclusion, the exclusion by its terms is limited to indices that contain only stocks that are registered under Section 12 of the Exchange Act. It is therefore likely to be of limited use for foreign stock index futures contracts. The SIA accordingly recommends that the Agencies adopt a version of the Market Cap/ADTV Exclusion applicable to indices that contain foreign stocks. Under such a test, an index could be considered broad-based if (i) the index has at least 9 component stocks, (ii) no component security comprises more than 30% of the index’s weighting, (iii) each component security is registered for trading under the laws of the jurisdiction of its principal market, if applicable, (iv) each component security has a market capitalization at least equal to that of the 750th largest U.S. stock by market capitalization

³ The Committee notes that, in order to conform to the language in proposed Exchange Act Rule 3a-55-3, proposed CFTC Rule 41.13 should be revised by adding “it would not be a narrow-based security index if” after “if”.

⁴ The exchange could also be required to provide supporting data upon request.

⁵ The foreign exchange could be required to agree to comply with appropriate additional requirements in the event the index ceased to be broad-based.

and (v) each component security has a Dollar ADTV at least equal to that of the 675th highest U.S. stock by Dollar ADTV.⁶

In addition, as a general matter, the SIA agrees with the views expressed by the Futures Industry Association (the “FIA”) that the Agencies should exercise their authority under Section 3(a)(55)(C)(iv) of the Exchange Act and Section 1a(25)(B)(iv) of the CEA to specify additional standards under which indices of foreign stocks would be treated as broad-based. As the Agencies note, certain foreign stock index futures contracts currently traded pursuant to CFTC staff no-action relief may fall within the Statutory Narrow-Based Definition and, accordingly, would be required to be traded as security futures following the end of the 18 month “grandfather” provision.⁷

There are also a number of country-based or sector-based indices that are the subject of futures trading on foreign exchanges but which may fall within the Statutory Narrow-Based Definition despite being a generally broad-based measure of the market for stocks in that country or sector. For example, depending on the composition of the relevant market, such an index might have a single stock that constitutes more than 30% of the index or might have 5 stocks that account for more than 60% of the index. Despite these factors, a contract on such an index might, in light of other aspects of the underlying market and the index composition, not be readily susceptible to manipulation or to being used as a surrogate for trading individual stocks in the index. For example, an index with 5 stocks accounting for more than 60% of the index might not raise such concerns if those stocks had sufficient market capitalization and/or Dollar ADTV. While the SIA does not support a standard that would characterize as broad-based an index that virtually replicates the performance of a single component stock, the SIA believes that the Agencies should adopt a more flexible approach to evaluating relative weightings and other factors relevant to index composition in the case of foreign stock index futures contracts.

In addition, although transactions in broad-based foreign stock index futures contracts would not be subject to the antifraud and antimanipulation provisions of the U.S. securities laws, it bears noting that such contracts are, in many cases, subject to similar prohibitions on fraud and manipulation in the jurisdiction of the relevant foreign exchange. This is particularly true in the case of jurisdictions that do not draw the same regulatory distinctions between securities and futures as exist in the United States. As a result, the consequences for market and investor protection of extending the broad-based index definition in the context of foreign stock index futures contracts may be limited.

In light of these considerations, the Agencies should consider a less expansive definition of narrow-based index for foreign stock index futures contracts, such as, among others, the approach proposed by the FIA in its comment letter concerning the Proposed Rules. The SIA stands ready to work with the Agencies and other interested parties in developing standards that would address the particular issues raised by foreign stock index futures contracts and take account of relevant differences between the U.S. and foreign markets for the underlying securities.

⁶ The Agencies could further simplify this test by specifying minimum levels of market capitalization and Dollar ADTV (based on that of the 750th and 675th U.S. stocks).

⁷ Section 1a(25)(B)(v) of the CEA and Section 3(a)(55)(C)(v) of the Exchange Act.

In addition, to the extent the Agencies are concerned that extending the broad-based definition might nonetheless lead to investor protection concerns or increased risk of market manipulation, it might be appropriate, as part of an exemption, to apply specific securities law provisions of U.S. securities laws, such as the fraud and manipulation prohibitions, to trading in such contracts. Concerns about fraud and manipulation can thus be addressed by means short of effectively prohibiting a significant range of foreign stock index futures contracts from being offered or sold in the United States.

5. Calculation of Market Capitalization, ADTV and Other Relevant Data.

The SIA appreciates the efforts of the Agencies to specify uniform standards for calculating Market Capitalization, ADTV, average price and other information relevant to the determination whether an index is broad-based or narrow-based. As an alternative to prescribing standards for these determinations, however, the SIA believes that it would be appropriate for the Agencies to permit exchanges to obtain this information directly from one or more recognized data vendors in the industry.⁸ This approach would eliminate the need for exchanges to engage in independent calculations of Market Capitalization, Dollar ADTV and other relevant information. By encouraging exchanges to use market-standard data sources, it would also help ensure uniformity of calculations across different exchanges. The possibility that data obtained from different providers could vary slightly or be calculated in a manner different from that proposed by the Agencies should not be material to the policy determination underlying the distinction between broad-based and narrow-based contracts—whether a contract on the index is subject to a material manipulation risk or use for surrogate trading.

To the extent the Agencies nonetheless determine to prescribe standards for calculating market capitalization and ADTV, the SIA urges the Agencies to be guided by the principles of reducing volatility and enhancing ease of calculation and transparency discussed above. In particular, the SIA believes that any such standards should permit exchanges to determine the status of stock indices on the basis of publicly available information. Requiring calculations on the basis of information that is not readily available from data vendors would be burdensome and serve no significant regulatory purpose.

The SIA acknowledges that there are a number of potential ways in which these parameters may be calculated. While a flexible approach would generally be desirable, the SIA is concerned that in this case flexibility may create a real possibility that different conclusions could be reached as to whether an index is narrow-based or broad-based depending on which of several reasonable calculation methods might be used.

a. Market Capitalization.

The Proposed Rules would require that market capitalization be calculated, for purposes of the Market Cap/ADTV Exclusion, by multiplying the number of outstanding shares

⁸ The Committee also does not believe that notification to the SEC or CFTC of the use of such third-party data should be required. Under the Proposed Rules, markets would be required to keep records of their determinations as to whether an index would be broad-based or narrow-based. These records, which would be available to the SEC and CFTC under the circumstances set forth in the Exchange Act and CEA, should be sufficient to permit the Agencies to perform their oversight responsibilities with respect to this issue.

of the security as reported in the most recent quarterly or annual report of the issuer by the transaction-volume-weighted average price of the security over the preceding six calendar months.

As an initial matter, while the volume-weighted average price at which all transactions in the relevant security are effected during the preceding six months may technically be the most accurate measure of average price, it is unlikely that this figure would differ significantly from the average closing price over the same period, a measure that would be much easier to calculate. As a result, the SIA recommends that the Agencies permit this alternative method of calculating average price.

In addition, the proposed measure of the number of outstanding shares may be imprecise in certain circumstances. In particular, markets should be permitted to take into account extraordinary events that affect the number of outstanding shares at the time they become effective, rather than only after annual or quarterly reporting periods. To the extent extraordinary events have an immediate effect on the market price of the security, which is taken into account in the average price used in the determining capitalization, related changes in the number of outstanding shares should be factored into the capitalization calculation at the same time. Updated share information between regular reporting periods could be obtained from the issuer's 8-K reports, information provided to the relevant market for the securities or relevant third-party data providers.

b. Method for Determining Dollar ADTV.

The Proposed Rules would calculate Dollar ADTV of a security for purposes of the Market Cap/ADTV Exclusion by multiplying the average daily share trading volume of the security over the preceding 6 calendar months by the transaction-volume-weighted average price of the security over that period.

The Proposed Rules generally would require that share trading volume be determined based on the number of shares traded on the principal market as well as certain other qualifying markets on the trading days of the principal market for the security during the relevant period. The SIA endorses the Agencies' determination to allow trading data on foreign markets to be included in the calculation, but questions whether the limitation to trading data reported to a foreign financial regulatory authority in the relevant jurisdiction is appropriate. It is not clear to the SIA, for example, that all relevant jurisdictions require such reporting.⁹ It might therefore be more appropriate, if a restriction of this type is deemed necessary, to permit the use of trading data derived from trading on foreign markets subject to surveillance by an appropriate foreign regulatory authority.

The SIA believes that, in the case of foreign underlying stocks, the trading volume and prices of transactions in American Depositary Receipts ("ADRs") on such securities should be considered in calculating Dollar ADTV. In addition, ADRs on securities registered

⁹ The Committee also notes that it is not entirely clear from the Proposed Rules whether data from non-U.S. exchanges is required to be taken into account in determining Dollar ADTV. If inclusion of such data is optional, it may lead to inconsistent determinations as to whether an index is broad-based or narrow-based.

under Section 12 of the Exchange Act should themselves be treated as so registered for purposes of eligibility to be included in indices relying on the Market Cap/ADTV Exclusion.

For purposes of the Statutory Narrow-Based Definition, the SIA generally supports the Agencies' decision to permit the use of non-volume-weighted average pricing in determining whether the Dollar ADTV of the lowest weighted 25% of an index exceeds the statutory threshold of \$50 million (or \$30 million in the case of indices with 15 or more component stocks). The SIA does not, however, believe that the Agencies should require the statutory threshold to be exceeded by at least 10% when using non-volume-weighted average pricing. Although it is true that the non-volume-weighted price could be less than the volume-weighted price, it could as easily be higher than the volume-weighted price. The possible difference in precision between using the non-volume-weighted price and the volume-weighted price in this context would not appear to be material in determining the extent to which a contract on an index is susceptible to being used as a surrogate for trading the underlying securities and accordingly whether it should be viewed as narrow-based.

The SIA also supports the provision in the Proposed Rules that the determination of the stocks representing the lowest weighted 25% of an index for purposes of the Statutory Narrow-Based Definition be made as of the relevant date of determination, rather than over a full six-month period. This approach will reduce the burden of determining compliance with the statutory requirements without undermining the distinction between narrow-based and broad-based indices. The SIA also endorses the Agencies' recognition that the weightings of stocks in the index for this purpose should be determined according to the calculation methodology for the particular index, rather than according to a standard specified by regulation.

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The SIA appreciates the opportunity to comment on the Proposed Rules and, as always, would be pleased to work with the SEC and CFTC staffs and other interested parties to address the issues discussed herein. Please do not hesitate to contact the undersigned (tel. 202-296-9410) or Jerry Quinn (tel. 212-618-0507), or our counsel, Edward J. Rosen (tel. 212-225-2820) or Geoffrey B. Goldman (tel. 212-225-2234) of Cleary, Gottlieb, Steen & Hamilton, if you have any questions regarding this letter.

Very truly yours,

cc: Hon. Laura S. Unger
Hon. Isaac C. Hunt, Jr.
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Hon. David D. Spears
Hon. Barbara Pedersen Holum
Hon. Thomas J. Erickson