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SEC AND CFTC ADOPT RULES IMPLEMENTING COMMODITY FUTURES MODERNIZATION ACT OF 2000

[13883] August 23, 2001 TO: INVESTMENT ADVISERS COMMITTEE No. 21-01 SEC RULES COMMITTEE No. 67-01 RE: SEC AND CFTC ADOPT RULES IMPLEMENTING COMMODITY FUTURES MODERNIZATION ACT OF 2000 As we previously advised you, in May the Securities and Exchange Commission (SEC) and the Commodity Futures Trading Commission (CFTC) proposed joint rules under the Securities Exchange Act of 1934 and the Commodity Exchange Act to implement new statutory provisions recently enacted through the Commodity Futures Modernization Act of 2000 (CFMA).1 Effective August 21, 2001, the SEC and CFTC approved the joint rules, which are briefly summarized below.2 OVERVIEW OF THE CFMA The CFMA, which became law on December 21, 2000, lifted a previous ban on 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. Specifically, the CFMA amended the definition of "security" in the Exchange Act, the Securities Act of 1933, the Investment Company Act, and the Investment Advisers Act to include a "security future." For purposes of each of these 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."3 The definition of "narrow-based security index" includes the terms "dollar value of average daily trading volume" (ADTV) and "market capitalization," which are not defined by statute. Instead, the CFMA directs the SEC and the CFTC to jointly specify by rule or regulation the methods to be used to determine the ADTV and "market capitalization" for purposes of this definition. 1 See Memorandum to Investment Advisers Committee No. 13-01 and SEC Rules Committee No. 38-01 (May 17, 2001). The proposing release may be found at 66 FED. REG. 27560 (May 17, 2001). 2 See SEC Release No. 34-44724 (August 20, 2001). A copy of the Release is available on the SEC's web site at www.sec.gov. Cites in this memorandum to the Release are to the version available on the SEC's web site. 3 The CEA and the Exchange Act provide various exclusions from the definition of "narrow-based security index. " One of these exclusions grants the SEC and the CFTC authority to jointly establish further exclusions from the definition of narrow-based security index. See Section 3(a)(55)(C)(vi) of the Exchange Act and Section 1a(25)(B)(vi) of the CEA. 2 SUMMARY OF THE RULES JOINTLY ADOPTED BY THE COMMISSIONS In accordance with the Congressional mandate, the joint rules provide the methods to be used to determine the ADTV and market capitalization and address other issues relating to implementation of the CFMA. The adopted rules are as follows: • RULE 3a55-1 UNDER THE EXCHANGE ACT AND RULE 41.11 UNDER THE CEA These rules establish a method for determining the dollar value of the ADTV of a security for purposes of the definition of "narrow-based security index." They include a provision that allows for the designation by the Commissions of a list of the Top

750 securities and Top 675 securities.4 The rules also establish how these securities can be determined in the absence of such designations. • RULE 3a55-2 UNDER THE EXCHANGE ACT AND RULE 41.12 UNDER THE CEA These rules address the circumstance when a broad-based security index underlying a future becomes narrow-based during the first 30 days of trading. Under the rules, the index will be excluded from the definition of narrow-based security index throughout that first 30 days if the index would not have been a narrow-based security index had it been in existence for an uninterrupted period of six months prior to the first day of trading. • RULE 3a55-3 UNDER THE EXCHANGE ACT AND RULE 41.13 UNDER THE CEA These rules provide that when a future on a security index is traded on or subject to the rules of a foreign board of trade, it will not be considered a narrow-based security index if it would not be a narrow-based security index if a future on that same index were traded on a designated contract market or registered derivatives transaction execution facility. In the Commissions' proposing release, they sought comment on the impact of these proposed rules on those futures contracts on indexes of foreign securities that are currently traded pursuant to no-action relief but for which such no-action relief will expire under the CFMA 18 months after the CFMA's enactment.5 According to the adopting release, while the Commissions believe "it is prudent" to adopt these rules as proposed, they nonetheless recognize the need to address those foreign index futures that will lose their no-action relief under the CFMA. In this regard, the release notes that "[t]he Commissions jointly will consider further amendments to the rules" relating to this issue and note that . . . the CEA and the Exchange Act grant [the Commissions] joint authority to exclude any security index from the definition of narrow-based security index by rule or by order that meets such requirements that they jointly establish. Because of ongoing business activities, the Commissions will consider using this 4 This designation is relevant for purposes of Section 3(a)(55)(C)(i) of the Exchange Act and Section 1a(25)(B)(i) of the CEA, which provide an exclusion from the definition of "narrow-based security index" for an index that meet certain criteria. One of these criteria is that each component security in the index is one of the 750 securities with the largest market capitalization ("Top 750") and one of the 675 securities with the largest dollar value of the ADTV ("Top 675"). 5 See Q12 in the proposing release at 66 FED. REG. 27564 (May 17, 2001). 3 authority in the case of foreign-based security indexes that are currently offered to U.S. investors pursuant to CFTC no-action letters, and may also consider using this authority as to foreign-based security indexes that may be developed in the future.6 • RULE 41.14 UNDER THE CEA This rule, which does not have a counterpart under the Exchange Act, provides that if the index becomes broad-based for no more than 45 business days over three consecutive calendar months, it will still be considered a narrow-based security index. * * * * * * As noted above, a copy of the adopting release is available on the SEC's web site (www.sec.gov). Tamara K. Reed Associate Counsel 6 See Release at p. 27.
