



DIVISION OF
MARKET REGULATION

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549 -

98-43
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March 12, 1999

Steven Manaster
Director
Division of Economic Analysis
Commodity Futures Trading Commission
Three Lafayette Center
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Washington, D.C. 20581

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Re: Application of the Kansas City Board of Trade for Contract Market Designation in the Internet Stock Price Index "ISDEX"² Futures Contract and Options on that Futures Contract

Dear Mr. Manaster:

Pursuant to Section 2(a)(1)(B) of the Commodity Exchange Act ("CEA"),¹ the Division of Market Regulation ("Division") of the U.S. Securities and Exchange Commission ("SEC" or "Commission") is responding to the request of the Commodity Futures Trading Commission ("CFTC") for the Commission's views on the application of the Kansas City Board of Trade ("KCBT" or "Exchange") for contract market designation to trade futures and futures options on the Internet Stock Price Index ("ISDEX").² Based on the information provided to the Division, and for the reasons noted below, the Division, on behalf of the Commission,

¹ Section 2(a)(1) of the CEA implements the terms of the 1982 jurisdictional accord ("Accord") between the SEC and the CFTC. Futures Trading Act of 1982, § 101, Pub. Law No. 97-444, 96 Stat. 2294 [codified at 7 U.S.C. § 2(a) (1983)].

² See Letter (with attachments) from Thomas M. Leahy, Financial Instruments Unit Chief, Division of Economic Analysis ("DEA"), CFTC, to Michael Walinkas, Deputy Associate Director, Division of Market Regulation ("Division"), SEC, dated December 15, 1998 ("CFTC Letter"); see also letter from Jeff C. Borchardt, Senior Vice President, KCBT, to Jean A. Webb, Secretary, CFTC, dated January 21, 1999 ("KCBT Supplement One"); letter from Jeff C. Borchardt, Senior Vice President, KCBT, to Jean A. Webb, Secretary, CFTC, dated February 22, 1999 ("KCBT Supplement Two"); letter from Jeff C. Borchardt, Senior Vice President, KCBT, to Jean A. Webb, Secretary, CFTC, dated February 25, 1999 ("KCBT Supplement Three"); letter from Jeff C. Borchardt, Senior Vice President, KCBT, to Jean A. Webb, Secretary, CFTC, dated March 1, 1999 ("KCBT Supplement Four"); and letter from Jeff C. Borchardt, Senior Vice President, KCBT, to Jean A. Webb, Secretary, CFTC, dated March 10, 1999 ("KCBT Supplement Five").

believes that the proposed contracts satisfy the statutory criteria. Consequently, the Division does not object to the designation of the KCBT as a contract market to trade the ISDEX futures and futures options.

I. Applicable Statutory Criteria

Section 2(a)(1)(B)(v) of the CEA prohibits any person from offering or selling a futures contract based on "any group or index of securities or any interest therein or based on the value thereof" except as permitted under Section 2(a)(1)(B)(ii). Section 2(a)(1)(B)(ii) of the CEA, in turn, permits the designation of a contract market for futures trading on an index or group of securities only if: (1) settlement of the futures contract (or options on such contract) is limited to the delivery of cash or exempted securities (other than municipal securities); (2) trading in the futures contract (or options on such contract) is not readily susceptible to manipulation, nor to causing or being used in the manipulation of the price of an underlying security, an option on such security, or an option on a group or index including such securities, and, in the case of futures options, the index-based futures contract underlying the options contract; and (3) the index or group of securities is a widely-published measure of, and reflects, the market for all publicly-traded equity or debt securities, or a substantial segment thereof, or is comparable to such measure.³ Pursuant to Section 2(a)(1)(B)(iv)(II) of the CEA, the SEC must determine that the futures contract (or options thereon) meets the eligibility standards described above in order for the CFTC to approve the proposed contract for trading.

³ As the SEC has noted in the past, this third criterion is intended, in part, to ensure that a securities index futures contract (or an option thereon) is not susceptible to manipulation and will not function as a surrogate for trading in individual securities or options on those securities. By helping to ensure that index futures (or options thereon) will not be used as a substitute for related options or stock trading, this requirement also mitigates competitive and investor protection concerns raised by the regulatory differences between the futures and securities markets or possible insider trading concerns regarding a security underlying an index through transactions in the futures market (or the options market thereon). See, e.g., Securities Exchange Act Release No. 40216 (July 16, 1998) (regarding the application of the Chicago Board of Trade for designation as a contract market to trade futures and futures options contracts on the Dow Jones Utilities Average Index and the Dow Jones Transportation Average Index) ("Commission Decision"); and Letter from William H. Heyman, Director, Division, SEC, to Joanne T. Medero, General Counsel, Office of the General Counsel, CFTC, dated August 23, 1991 (regarding the application of the Sydney Futures Exchange to permit the offer and sale to U.S. persons of futures contracts overlying the All Ordinaries Share Price Index) ("All Ordinaries Index Futures Letter").

II. Description of the KCBT's Proposal

The KCBT proposes to trade futures and futures options on the ISDEX, a stock index developed and maintained by Internet.com LLC ("Company")⁴ that measures the stock performance of companies whose primary business is internet-related. According to International Data Corporation ("IDC") estimates provided by the KCBT, at the end of 1997 there were over 38 million internet users in the United States and over 68 million worldwide. By 2002, those figures are projected to increase to 135 million and 319 million, respectively. With the proliferation of new internet users comes new commerce, content, software, hardware, and services to meet this burgeoning market. For example, IDC estimates that transactions on the internet are expected to increase from approximately \$12 billion in 1997 to approximately \$426 billion in 2002. The companies supporting the internet and its growth are likewise experiencing rapid increases in their revenues and market capitalizations. According to the KCBT, the projected capitalizations for the stocks comprising the ISDEX could appreciate 35% or more per annum over the next five years.

As defined by the Company, the internet industry segment covers a broad range of companies, including those participating in the following internet business sub-segments: (1) e-commerce - buying and selling of goods and services on the internet; (2) software - developing and selling software that enables companies and individuals to connect, create, and control their access to and appearance on the internet; (3) hardware - manufacturing or providing servers, routers, and other network infrastructure devices for managing an internet presence; (4) security - creating software and other devices that protect internet sites and users from fraud, theft, or unauthorized access; (5) content - providing information, data, and editorial content for the internet; (6) high-speed services - providing physical connectivity to the internet such as cable, DSL, and other next generation infrastructure; and (7) access - providing access to and from the internet (e.g., internet service providers).

According to the KCBT's proposal, the ISDEX is a modified capitalization weighted index comprised of 50 internet stocks traded on the New York Stock Exchange ("NYSE") and the Nasdaq Stock Market ("Nasdaq"). The ISDEX includes the equity securities of companies engaging in the seven above-identified internet business sub-segments. As of February 12, 1999, these 50 component stocks represented approximately \$380 billion in market capitalization; this represents approximately 95% of the capitalization of the entire internet industry as defined by the Company. The average daily trading volume for the component

⁴ The KCBT has characterized the Company as a provider of information related to all aspects of the internet and described the company as the primary dedicated provider of news and information about the internet industry to the public. See KCBT Supplement Two.

stocks over the six month period from May 1998, through October 1998, ranged from a low of 104,465 shares to a high of 17,851,448 shares.

In constructing the ISDEX, the Company used a multi-faceted and overlapping approach to identify and screen a broad range of public companies primarily engaged in internet-related businesses. At the outset of the screening process, the Company reviewed a comprehensive list of internet stocks provided by Securities Data, Inc., a subsidiary of Thomson Financial Services. Securities Data included in the list all companies identified through proprietary research which it believed could be classified as internet companies. Securities Data prepared the list by identifying those companies subject to SEC reporting obligations that included keywords such as "internet", "world wide web," or "on-line" in their primary business descriptions. In the next phase of screening, the Company reviewed public information for additional stocks involved in the internet industry that are listed on the NYSE, Nasdaq, American Stock Exchange ("Amex"), regional exchanges, as well as stocks traded in the pink sheets. In the third level of screening, the Company reviewed all initial public offerings filed since 1995 to identify other companies that have a significant relationship with the internet. In the final stage of the screening process, the Company identified those companies which it believes are "true" internet companies. Because no widely-accepted industry standard currently exists to determine whether a company is a "true" internet company, the Company devised its own test. Under the Company's test, a company is considered to be an internet company if it derives at least 51% of its revenues from the internet industry ("51% revenue test"). The application of this test to the candidate ISDEX issues identified approximately 89 companies as internet companies. Of the 89 companies, the Company selected 50 to be included in the ISDEX.

As a general rule, the Company will review the ISDEX component stocks each calendar quarter to ensure the ISDEX contains stocks that are most representative of the internet industry. The Company's goal is to include in the ISDEX the leading stocks from each of the seven internet business sub-segments. Actions such as the development of a new type of service, change in business direction, or entry into a new market sector will be considered when evaluating the stocks within the ISDEX to assure a proper mix of stocks that best represent the entire internet industry. Leading firms are measured by one or more of the following key metrics: overall market share (determined by sales versus peers), revenues, earnings, monthly unique users, monthly page views, alliances, strategy, and execution of strategy. Companies that no longer represent their respective sub-segment from a leadership position, as measured by the key metrics, may be replaced by other internet companies upon quarterly review of the ISDEX by the ISDEX review committee. The ISDEX review committee consists of senior management from the Company and is led by a senior investment analyst also from the Company.

To inform market participants of any quarterly changes to the composition of the ISDEX, the KCBT and the Company will provide advance public notice (by press release, website posting, or both) of any change in ISDEX components during the last five business days of the calendar quarter. The advance public notice will identify the component stocks being removed from the ISDEX and the stocks being added to the ISDEX. The Company will review ISDEX component stocks more frequently than each quarter if necessary in the case of mergers, acquisitions, or other significant events (e.g., bankruptcy).⁵ The replacement for any component stock removed from the ISDEX shall be selected according to the screening methodology used by the Company to select the initial 50 ISDEX components.

The ISDEX is calculated using a modified capitalization weighted methodology. Specifically, the ISDEX is calculated by dividing the summed market value of the ISDEX component stocks by the index divisor. The market value of any particular stock is calculated by multiplying its price times the number of adjusted shares outstanding.

Under the modified capitalization weighted methodology, the Company has agreed to modify the ISDEX so that no single component stock initially constitutes more than 10% of the weight of the ISDEX ("10% test"). This test was designed to prevent the ISDEX from being dominated by one or several component stocks. For example, because the market capitalization of the ISDEX component stock Cisco is very large (as of February 12, 1999, approximately \$156.4 billion, or 41% of the total ISDEX capitalization on a pure capitalization weighted basis), the number of outstanding shares of Cisco considered in the calculation of ISDEX would be limited to a number such that the weighting of Cisco would represent no more than 10% of the capitalization of all component stocks in the ISDEX.⁶ Therefore, if the adjustment to Cisco's outstanding shares required to limit Cisco's participation to no more than 10% of the capitalization resulted in a weighting factor of .15, then only 15% of Cisco's 1.569 billion outstanding shares, or about 235 million shares, would be used to calculate the ISDEX under the modified capitalization weighted methodology.

⁵ Although the KCBT and the Company shall endeavor to provide advance public notice of intra-quarter stock replacements within five business days preceding the replacement, in no case shall notice be provided later than the start of trading on the day of replacement. Telephone conversation between Jeff C. Borchardt, Senior Vice President, KCBT; and Michael L. Loftus, Attorney, Division, SEC (March 11, 1999). See also KCBT Supplement Five.

⁶ Similar adjustments also shall be made to the number of outstanding shares for America Online and Yahoo! As of February 12, 1999, these two ISDEX component stocks had unadjusted market capitalizations of \$74 billion and \$29.8 billion, respectively.

Following the initial weighting, the weights of the ISDEX component stocks will be reviewed and adjusted if necessary at the end of each calendar quarter. Adjustments will be made when any single component stock's weight exceeds 15% of the total capitalization of all component stocks in the ISDEX. When such an adjustment is made, each component stock whose weight is greater than 10% shall be adjusted downward so that its weight is less than or equal to 10%.⁷ The KCBT and the Company shall provide public notice of the new weights as soon as practicable so that market participants can ascertain the components' relative weight in the ISDEX during the next calendar quarter. If no component stock's weight exceeds 15% at the end of a calendar quarter, no adjustments will be made to the component weightings for the next calendar quarter.

Each ISDEX futures contract will be valued at \$100 times the value of the ISDEX. Prices for ISDEX futures will be quoted in terms of points of the ISDEX, with a minimum price fluctuation of 0.05 points, equivalent to \$5 per contract. The contract delivery months will be March, June, September, and December. The last trading day of a delivery month is the third Friday of the month. Although there are no upside price limits governing the ISDEX futures contract, KCBT shall maintain downside price limits corresponding to a 5%, 10%, 15%, and 20% decline below the previous day's settlement price. Delivery under the ISDEX futures contract will be by cash settlement. The ISDEX cash index value (i.e., ISDEX value times \$100) at the close of trading on the last trading day will be used to settle all remaining open positions. If, on the last trading day of the ISDEX futures contract, the underlying securities exchanges on which the ISDEX components trade are closed, the final settlement price for the ISDEX futures and options contracts shall be based on the closing value of the ISDEX on the preceding business day. If the underlying securities exchanges open for trading on the last trading day but close early and do not reopen, the last ISDEX value available at the early closing shall be used for final settlement of ISDEX futures and options. Speculative position limits for the ISDEX futures contract are 5,000 contracts net long or short in all contract months combined.

For options on the ISDEX futures contract, the exercise prices shall be stated in terms of the ISDEX futures contract that is deliverable upon exercise of the option. The dollar amount of the interval between strike prices shall be \$500, equivalent to five point (5.00) intervals. Prices of ISDEX options shall be quoted in tenths of a point, the minimum price fluctuation shall be one tenth of one point (.10) or \$10.00. For options that expire in the March quarterly cycle, options trading shall terminate at the same date and time as the underlying futures contract. For options that expire in months other than those in the March

⁷ The KCBT anticipates that a stock's weighting ordinarily will be adjusted downward to approximately 10%; however, the KCBT acknowledges that a stock's weighting may be adjusted below 10% if necessary to prevent the ISDEX from becoming skewed in favor of one or more sub-segments. See KCBT Supplement Five.

quarterly cycle, options trading shall terminate on the third Friday of the contract month. If that day is not a KCBT business day, then options trading shall terminate on the first preceding business day.

An option may be exercised any time prior to expiration. Options so exercised will be settled not later than the close of trading on the business day following the exercise date. On the last trading day, all open long, in-the-money positions in ISDEX options (*i.e.*, the exercise price is less, in the case of call options, or greater, in the case of put options, than the settlement price of the underlying futures contract on the last trading day of the expiring option) shall be automatically exercised unless instructions to the contrary are delivered to the KCBT Clearing Corporation by 4 PM on the last trading day. Position limits for options on the ISDEX futures prohibit a person from owning or controlling a combination of options and underlying futures contracts that exceeds 5,000 futures-equivalent contracts net on the same side of the market in all contract months combined.

III. Discussion of Statutory Criteria

A. Settlement in Cash

The settlement of the ISDEX futures contract is limited to the delivery of cash. In addition, options on the ISDEX futures contract will be settled, if exercised, through delivery of the underlying futures contract. Accordingly, because there is no delivery or transfer of securities in the settlement of either the ISDEX futures or futures options, the first statutory standard is satisfied.

B. Not Readily Susceptible to Manipulation

The Division typically has considered several factors in evaluating whether trading in a futures contract (or options on such contract) on a securities index is not readily susceptible to manipulation, nor to causing or being used in the manipulation of the price of an underlying security, an option on such security, or an option on a group or index including such securities, and, in the case of futures options, the index-based futures contract underlying the options contracts. These factors include: (1) the number of securities comprising the index or group; (2) the capitalization of those securities; (3) the depth and liquidity of the secondary markets for those securities; (4) the diversification of the group or index; (5) the manner in which the index group is weighted; and (6) the ability to conduct surveillance of the futures contract and the underlying securities.⁸ These criteria, along with the requirement that the

⁸ See, *e.g.*, All Ordinaries Index Futures Letter, *supra* note 3; Letter from Jonathan G. Katz, Secretary, SEC, to Paula A. Tosini, Director, DEA, CFTC, dated August 24, 1987 (regarding the application of the CBOT to offer and sell futures contracts based on the

group or index of securities be broad-based, are designed to ensure that the underlying securities are sufficiently capitalized, liquid, and diverse so as to make the futures and related markets not readily susceptible to manipulation. In addition, these criteria help to ensure that the index calculation method accurately represents the value of the component securities and that there is a mechanism in place to detect and deter trading abuses.

The Division concludes that the ISDEX futures contract and options on ISDEX futures contracts are not readily susceptible to manipulation nor to causing or being used in the manipulation of any related market, given the number of components and the diversification of the ISDEX within the internet segment, the capitalization of the ISDEX, the weighting methodology of the ISDEX, and the deep and liquid markets of the securities comprising the ISDEX.

The Division observes that the ISDEX is comprised of 50 securities which represent a broad cross-section of the internet segment of the U.S. market. The Division notes that the ISDEX is a modified capitalization weighted index whose value is more difficult to affect than that of a price weighted index. As of February 12, 1999, the ISDEX has a low concentration of weighting, with no single security representing more than 10% of the weight of the ISDEX and the top three stocks only representing 30% of the weight of the ISDEX.

Seven sub-segments of the internet industry are represented by the ISDEX; specifically, e-commerce, software, hardware, security, content, high-speed services, and access. As of March 3, 1999, no single internet sub-segment consisted of more than seventeen component stocks and no single internet sub-segment represented more than 27.2% of the weight of the ISDEX.

As of February 12, 1999, the total capitalization of the ISDEX, before modifications, was approximately \$380 billion. This represents approximately 2.7 percent of the total capitalization of the NYSE as of December 1998. After modifying the weightings of the highest capitalization ISDEX components to comply with the 10% test, the ISDEX has a total capitalization of \$171.7 billion. The highest capitalization component securities (America Online, Cisco, and Yahoo!) each have a capitalization of approximately \$17.2 billion (10% of the total ISDEX capitalization), while the lowest weighted security has a capitalization of approximately \$146.6 million. In addition, all of the ISDEX's component stocks are actively traded, with the average daily trading volume for the individual component stocks over the six

(...continued)

Long-Term Corporate Bond Index); and Letter from William H. Heyman, Director, Division, SEC, to Joanne T. Medero, General Counsel, CFTC, dated September 24, 1991 (regarding the application of the CBOT for designation as a contract market to trade options on the CBOT Major Market Index futures contracts).

month period from May 1998, through October 1998, ranging from a low of 104,465 shares to a high of 17,851,448 shares. Based upon its review of these factors, the Division believes that it is unlikely that attempted manipulations of the prices of a small number of issues would significantly affect the value of the ISDEX.⁹

Another significant factor the Division considers in evaluating the potential for manipulation of proposed stock index futures contracts and futures options is the existence of comprehensive surveillance sharing arrangements between the futures and the underlying securities markets. The Commission notes that the KCBT belongs to the Intermarket Surveillance Group ("ISG").¹⁰ The members of the ISG have agreed to share information relating to any financial instrument traded through the facilities of any party, upon request and subject to certain restrictions, including but not limited to, market trading activity, clearing activity, and the identity, trading activity and positions of the self-regulatory organization's ("SROs") members or customers of the SRO members.¹¹ Such surveillance sharing agreements are an important mechanism for surveillance and a way to ensure the availability of information among markets in order to detect and deter potential manipulations and other trading abuses, thereby making the stock index derivative product less readily susceptible to manipulation.

In addition, the Company has established policies and procedures to prohibit insider trading with respect to ISDEX futures and options. The Company has represented that it treats very seriously any suspected insider trading, as well as the Company's access to advance information regarding the makeup of the ISDEX and changes to the components. As part of the License Agreement between the Company and KCBT, all officers and employees of both the Company and the KCBT are expressly prohibited from trading ISDEX futures or options.

⁹ The Division recognizes that the ISDEX has a relatively low capitalization when measured in relation to the total NYSE capitalization. However, for the same reasons set forth infra in Section III.C. of this letter, the Division believes that potential manipulation concerns have been adequately addressed by the KCBT proposal.

¹⁰ See KCBT Supplement Two.

¹¹ The NYSE, Nasdaq, and the Amex, along with the regional national securities exchanges are members of ISG, and the futures exchanges are affiliate members of ISG. ISG was formed to coordinate more effectively surveillance and investigative information sharing agreements in the stock and options markets. Because of the potential opportunities for trading abuses involving stock index futures, stock options and the underlying stocks, and the need for greater sharing of surveillance information to detect these potential intermarket trading abuses, the major U.S. futures exchanges that trade stock index futures are affiliate members of ISG.

For all of the above reasons, the Division believes that the ISDEX futures contracts and options thereon are not readily susceptible to manipulation.

C. Substantial Segment of the Market

The CEA requires that the ISDEX is a measure of and reflects the market for all publicly traded equity or debt securities or a substantial segment thereof. This standard reduces the likelihood that trading in an index could act as a surrogate for trading the individual securities, in addition to minimizing the potential for manipulation, among other things.

The SEC has previously applied a totality of the circumstances approach to determining whether a stock index measures and reflects the overall equities market or a substantial segment of that market. The factors generally considered include the number of component securities, the diversity of the index, the design and structure of the index, and the overall capitalization of the index.¹² This is a flexible approach where no one factor is necessarily dispositive.

As an initial matter, the Division concludes that the internet segment of the U.S. equities market constitutes a "substantial" segment of the overall public U.S. equities market for purposes of the statute.¹³ In particular, the 89 stocks identified by the Company represent a market capitalization of approximately \$400 billion. In addition, industry estimates for the next several years indicate that the internet will continue to experience tremendous growth in the number of users and the number of new business opportunities connected to that growth. This growth has spawned numerous publicly traded companies that conduct business in the previously-defined internet sub-segments. Therefore, the internet segment is recognized as a discernible, unique segment of the overall market that operates, in part, as a vehicle for equity market participants to hold direct interests in companies engaging in internet-related business.

The Division believes the internet segment is a rapidly developing and evolving market segment that is an important part of the U.S. equities markets. The Division notes that the breadth

¹² The Commission also looks at the weighting of the largest stock and largest group of stocks in an index, the depth and liquidity of the trading in the component securities, and the public float of the securities. See Commission Decision, supra note 3, at note 43.

¹³ See Letter from Richard R. Lindsey, Director, Division, SEC, to Steven Manaster, Director, DEA, CFTC, dated November 23, 1998 (regarding the application of the Chicago Mercantile Exchange for contract market designation in the Standard and Poor's REIT Composite Index futures contract and options on that futures contract).

and pervasiveness of the internet make the internet segment difficult to define. Specifically, because of the widespread use of the internet and its impact on global commerce, most public companies' business is to some extent internet-related. Therefore, the difficulty lies in identifying and separating the "true" internet companies from other companies having a less significant relationship to the internet. In light of this difficulty, the Division believes that the Company's "51% revenue test" is a reasonable mechanism for determining whether a company is included in the internet segment.

The Division also believes that the ISDEX is sufficiently broad to reflect the diversity of the internet sector, because, *inter alia*, the ISDEX includes companies from each of the seven sub-segments identified by the Company.¹⁴ The ISDEX consists of 50 components out of the approximately 89 internet securities identified by the Company. These 50 securities are diverse, representing a broad cross-section of the internet segment of the U.S. market.

As of February 12, 1999, the total capitalization of the ISDEX, before modifications, was approximately \$380 billion. This represents approximately 2.7 percent of the total capitalization of the NYSE as of December 1998. After modifying the weightings of the highest capitalization ISDEX components to comply with the 10% test, the ISDEX has a total capitalization of \$171.7 billion. The highest capitalization component securities (America Online, Cisco, and Yahoo!) each have a capitalization of approximately \$17.2 billion (10% of the total ISDEX capitalization), while the lowest weighted security has a capitalization of approximately \$146.6 million. In addition, all of the ISDEX's component stocks are actively-traded, with the average daily trading volume for the component stocks over the six month period from May 1998 through October 1998, ranging from a low of 104,465 shares to a high of 17,851,448 shares. As of March 3, 1999, no single internet sub-segment consisted of more than seventeen component stocks and no single internet sub-segment represented more than 27.2% of the weight of the ISDEX. Finally, the Division notes that the Company has procedures for actively maintaining the ISDEX to ensure that the components continue to satisfy the key metrics and represent their respective internet sub-segments.¹⁵

The ISDEX's modified capitalization weighting methodology, total market capitalization, and component trading history also strengthen the KCBT's proposal. The ISDEX has a low concentration of weighting, with no single security representing more than 10% of the weight of the ISDEX and the top three stocks only representing 30% of the weight

¹⁴ If this factor was to change, the Division believes that such a change could constitute a material change that would require the Division to reexamine the conclusions reached in this letter.

¹⁵ See *supra* Section II for maintenance details.

of the ISDEX (as of February 12, 1999). The ISDEX is a modified capitalization weighted index, whose value is more difficult to affect than that of a price weighted index.

The Division also notes that the ISDEX will be a widely published index. According to KCBT plans, the ISDEX value will be calculated by Bridge Information Systems ("Bridge") every 15 seconds during market hours. Bridge will provide these real time ISDEX calculations to the KCBT for dissemination to market data vendors.

The Division recognizes that the ISDEX, a single industry index for purposes of the 1984 SEC/CFTC Joint Policy Statement,¹⁶ has a relatively low capitalization when measured in relation to the total NYSE capitalization. The Division does not believe that the weakness of this factor is fatal to the KCBT's proposal satisfying the statutory requirements. Rather, the Division believes that several other factors, including the number of stocks in the ISDEX, the design and structure of the ISDEX (low concentration of weighting and modified capitalization weighted), the diversity within the segment, the liquidity of the underlying stocks, and the existence of adequate surveillance measures, overcome the potential risk of manipulation that would ordinarily cause the Division to object to an index with such relatively low capitalization. Based on this analysis, the Division has concluded that the ISDEX meets the requirements of Section 2(a)(1)(B)(ii) of the CEA.

IV. Conclusion

For the reasons set forth above and based on the information and representations presented, the Division does not object to the designation of the KCBT as a contract market to trade ISDEX futures contracts or options on those futures contracts. This conclusion is based solely on the facts and representations contained in this letter. If any of the representations were untrue or if any fact or any term of either of the contracts were to change in any material

¹⁶ The Division notes that the ISDEX also meets the minimum criteria set out in the SEC/CFTC Joint Policy Statement for single industry (as opposed to market) stock indexes of domestic issuers. See Commodity Futures Trading Commission and Securities and Exchange Commission Release No. 20578 (Jan. 18, 1984), 49 FR 2884 (Jan. 24, 1984). Specifically, the Index consists of more than 25 components, its capitalization is greater than \$75 billion, no single component has a capitalization exceeding 25% of the aggregate capitalization, and the aggregate capitalization of the three components having the highest capitalization does not exceed 45% of the aggregate capitalization. The criteria stated in the Joint Policy Statement are in any event not mandatory, but only guidelines used for the Commission's review of applications for contract market designation.

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respect,¹⁷ the Division would have to reevaluate the conclusions reached herein in light of those changes. The Division expresses no view with respect to any other question that the proposed contracts may raise, including, but not limited to, the applicability of other federal or state laws.

Pursuant to delegated authority,¹⁸



Robert L.D. Colby
Deputy Director

¹⁷ If the terms of the KCBT's futures or futures options contracts are changed in a material way, or if the composition of the ISDEX were to change in any material way, the Commission believes that it would be necessary to publish notice of that change as an amendment to the contract in order to afford the public an opportunity to review the proposed contract and for the SEC to review its prior determination. Compare Letter from George A. Fitzsimmons, Secretary, SEC, to Paula A. Tosini, Director, DEA, CFTC, dated July 23, 1984; and letters from Jonathan G. Katz, Secretary, SEC, to Paula A. Tosini, Director, DEA, CFTC, dated August 24, 1987, and April 18, 1988; with letter from Jean A. Webb, Secretary, CFTC, to John Wheeler, Secretary, SEC, dated May 31, 1985; letter from Jean A. Webb, Secretary, CFTC, to Jonathan G. Katz, Secretary, SEC, dated October 1, 1987; and letter from Marshall E. Hanbury, General Counsel, CFTC, to Jonathan G. Katz, Secretary, SEC, dated May 31, 1988.

¹⁸ 17 CFR 200.30-3(e).