

# COMMODITY FUTURES TRADING COMMISSION

## 17 CFR Part 41

**RIN: 3038-AB87**

Listing Standards and Conditions for Trading Security Futures Products

**AGENCY:** Commodity Futures Trading Commission

**ACTION:** Final Rules

**SUMMARY:** The Commodity Futures Trading Commission (“CFTC” or “Commission”) is promulgating rules 41.21 through 41.25 under the Commodity Exchange Act (“CEA”).<sup>1</sup> These rules relate to new statutory provisions enacted by the Commodity Futures Modernization Act of 2000 (“CFMA”)<sup>2</sup> that specify listing standards and conditions for trading of security futures products. These rules also establish requirements related to the self-certification of rules and rule amendments, reporting of data, speculative position limits, and special provisions relating to contract design for cash settlement and physical delivery of security futures products.

**EFFECTIVE DATE:** [Insert date of publication.]

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<sup>1</sup> 7 U.S.C. 1 et seq.

<sup>2</sup> Pub. L. No. 106-554, 114 Stat. 2763 (December 21, 2000).

**SUPPLEMENTARY INFORMATION:** The Commodity Futures Trading

Commission today promulgates new rules 41.21 through 41.25 under 17 C.F.R. part 41, pursuant to the CEA as amended by the Commodity Futures Modernization Act of 2000 (7 U.S.C. 1 et seq., as amended by Appendix E of Pub. L. No. 106-554, 114 Stat. 2763).

**I. BACKGROUND**

A. Overview

On December 21, 2000, the CFMA was signed into law. Among other things, the CFMA lifted the ban on single stock and narrow-based stock index futures (“security futures”).<sup>3</sup> In addition, the CFMA established a framework for the joint regulation of security futures products<sup>4</sup> by the CFTC and the Securities and Exchange Commission (“SEC”).<sup>5</sup> Section 2(a)(1)(D) of the CEA and Section 6(h) of the Securities Exchange Act of 1934, as amended by the CFMA, provide that in order for a board of trade to list security futures products, the security futures products and the securities underlying the security futures products must meet a number of standards and conditions termed “listing standards.”

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<sup>3</sup> See Section 251(a) of the CFMA. This trading previously was prohibited by Section 2(a)(1)(B)(v) of the CEA.

<sup>4</sup> The term “security futures product” is defined in Section 1a(32) of the CEA and Section 3(a)(56) of the Exchange Act to mean “a security future or any put, call, straddle, option, or privilege on any security future.” The term “security future” is defined in Section 1a(31) of the CEA and Section 3(a)(55)(A) of the Exchange Act to include futures contracts on individual securities and on narrow-based security indexes. The term “narrow-based security index” is defined in Section 1a(25) of the CEA and Section 3(a)(55)(B) of the Exchange Act. Because the CFMA also provides that options on security futures cannot be traded until at least December 21, 2003, security futures are the only security futures product that may be available for trading until that date.

<sup>5</sup> The CFMA also prescribes the dates on which security futures trading can commence. Specifically, trading on a principal-to-principal basis between eligible contract participants was not permitted until August 21, 2001, and retail transactions cannot commence until December 21, 2001. Both starting dates are conditioned upon the registration of a futures association as a national securities association under the Exchange Act. See Section 202(a) of the CFMA; Section 6(g)(5) of the Exchange Act.

Security futures products may be traded on any board of trade that is designated as a contract market by the Commission pursuant to Section 5 of the CEA or that is registered with the Commission as a derivatives transaction execution facility (“DTEF”) pursuant to Section 5a of the CEA. In addition, Section 5f(a) of the CEA permits certain entities that are otherwise regulated by the SEC to be designated contract markets for the limited purpose of trading security futures products. Specifically, any board of trade that is registered with the SEC as a national securities exchange pursuant to Section 6(a) of the Exchange Act, is registered with the SEC as a national securities association pursuant to Section 15A(a) of the Exchange Act, or is an alternative trading system (“ATS”) as defined by Section 1a(1) of the CEA shall be a designated contract market in security futures products if certain conditions are met.<sup>6</sup>

On July 20, 2001, the Commission published for comment proposed rules 41.21 through 41.25,<sup>7</sup> which addressed issues related to listing standards and established uniform requirements related to position limits, as well as provisions to minimize the potential for manipulation and disruption to the futures markets and underlying securities markets.<sup>8</sup> The proposed rules also related to the allowable types of securities underlying security futures products; settlement procedures; who may deal in security futures

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<sup>6</sup> See 66 FR 44960 (August 27, 2001). In that notice, the Commission adopted new regulations that provide notice registration procedures for a national securities exchange, a national securities association, or an alternative trading system to become a designated contract market in security futures products. By registering with the Commission, a national securities exchange, a national securities association, or an alternative trading system is, by definition, a designated contract market for purposes of trading security futures products. Hence, references in these rules to designated contract markets include notice designated contract markets, except where otherwise noted.

<sup>7</sup> See 66 FR 37932 (July 20, 2001).

<sup>8</sup> Additional rules related to trading halts and the cash settlement of security futures products were proposed in a joint rulemaking by the Commission and the SEC. See 66 FR 45903 (August 30, 2001).

products; restrictions on dual trading; and rules governing surveillance, audit trails, trading halts, and margin requirements.

It should be noted that in addition to satisfying the listing standards of the CEA, security futures products must conform to listing standards that a national securities exchange or national securities association files with the SEC under Section 19(b) of the Exchange Act.<sup>9</sup> In addition, Section 6(h)(3)(C) of the Exchange Act imposes the additional requirement that the exchange or association's listing standards for security futures products must be no less restrictive than comparable listing standards for security options. On September 5, 2001, the SEC issued guidance for boards of trade as to the listing standards that would satisfy this requirement.<sup>10</sup>

#### B. The Proposed Rules

The Commission proposed rule 41.21 to address the statutory requirements for securities that may underlie security futures products.<sup>11</sup> Under the proposed rules, eligible securities must be securities registered pursuant to Section 12 of the Exchange Act and must be common stock or other equity securities as the Commission and the SEC deem appropriate. The proposed rules further provided that the securities must conform to any listing standards the designated contract market or registered DTEF files with the SEC.

The Commission proposed rule 41.22 to make it unlawful for a designated contract market or registered DTEF to list for trading or execution a security futures product unless it provided the Commission with a certification that the security futures

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<sup>9</sup> See Section 6(h)(2) of the Exchange Act.

<sup>10</sup> See Division of Market Regulation Staff Legal Bulletin No. 15 (September 5, 2001). The Staff Legal Bulletin is available on the SEC's website at <http://www.sec.gov/interps/legal/mrslb15.htm>.

product and the board of trade meet specified requirements set forth in the CEA.<sup>12</sup> Accordingly, proposed rule 41.22 would require designated contract markets and registered DTEFs to certify that they meet the requirements of Section 2(a)(1)(D)(i) of the CEA. That rule required certifications regarding the types of securities underlying security futures products; the payment and delivery of security futures products; who may trade security futures products; dual trading; anti-manipulation provisions; coordinated surveillance; audit trails; trading halts; and margin requirements.

With respect to the coordinated surveillance requirement, Section 2(a)(1)(D)(i)(VIII) of the CEA requires designated contract markets and registered DTEFs on which security futures products are traded to coordinate surveillance with markets that trade the underlying security or any related security, in order to detect manipulation and insider trading. This requirement was proposed to be implemented by paragraph (g) of proposed Section 41.22, which would require that a board of trade certify that it is a full member of the Intermarket Surveillance Group (the “ISG”).<sup>13</sup>

Proposed rule 41.23 described the procedures for filing documents with the Commission before a designated contract market or registered DTEF could trade a security futures product. Specifically, proposed rule 41.23(a) described the documents

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<sup>11</sup> See Sections 2(a)(1)(D)(i)(I) and (III) of the CEA, as created by Section 251 of the CFMA.

<sup>12</sup> See Section 2(a)(1)(D)(vii) of the CEA.

<sup>13</sup> The Intermarket Surveillance Group was created under the auspices of the SEC in 1983 as a forum to ensure that national securities exchanges and national securities associations adequately share surveillance information and coordinate inquiries and investigations designed to address potential intermarket manipulations and trading abuses. All national securities exchanges and national securities associations are full members of the ISG. Full members routinely share a great deal of surveillance and investigatory information, and this framework has proven to be an essential mechanism to ensure that there is adequate information sharing and investigatory coordination for potential intermarket manipulations and trading abuses. In view of the growth of stock index futures contracts, since 1987, several futures exchanges and non-U.S. exchanges and associations have become affiliate members of the ISG. Affiliate members are required to share information on a more limited basis with the ISG.

that must be filed with the Commission, including documents and certifications required by proposed rules 41.22 and 41.25. Proposed rule 41.23(b) described the procedures for voluntary submission by designated contract markets and registered DTEFs for Commission approval of security futures products, as permitted by Section 5c(c)(2) of the CEA. The proposed rule noted that notice designated contract markets are not permitted to request Commission approval of security futures products, since they are exempt from the provisions of 5c of the CEA by virtue of Section 5f(b)(1)(D) of the CEA.

Proposed rule 41.24 required designated contract markets (including notice designated contract markets) and registered derivatives clearing organizations to file with the Commission a copy of any rule or rule amendment. Proposed paragraph (b) mandated that the procedures of paragraph (a) also apply to the self-certification of rules relating to security futures products by registered DTEFs, notwithstanding the provisions of rule 37.7. Proposed paragraph (c) allowed a designated contract market, registered DTEF, or registered derivatives clearing organization to submit rules for Commission approval, as permitted by Section 5c(c)(2) of the CEA. However, under the proposed rule, notice designated contract markets would not be permitted to request Commission approval of rules, since Section 5f of the CEA exempts these entities from Section 5c(c)(2) of the CEA.

Proposed rule 41.25 established requirements related to data reporting, trading halts, speculative position limits, and certain contract design features related to the settlement of security futures products. The Commission proposed paragraph (a)(1) of rule 41.25 to require designated contract markets and registered DTEFs to comply with Part 16 of the Commission's regulations regarding the daily reporting of market data.

Paragraph (a)(2) was reserved for the establishment of rules providing for trading halts for security futures products, which the Commission and the SEC jointly proposed in a separate release.<sup>14</sup>

Paragraph (a)(3) of proposed rule 41.25 required designated contract markets and registered DTEFs to adopt speculative position limits or position accountability rules for listed security futures products. The level of the position limit and whether a position limit is required would depend upon the trading activity and capitalization of the security or securities underlying the security futures product.

Paragraph (b) of proposed rule 41.25 established requirements for security futures products that are cash settled. Paragraph (b) was, in part, reserved for rules relating to acceptable cash settlement prices of security futures products. In this regard, in a separate release, the Commission and the SEC jointly proposed rules relating to the acceptable procedures for setting cash settlement prices for security futures products.<sup>15</sup> Proposed paragraph (c) of rule 41.25 established requirements related to security futures products that are settled by physical delivery of the underlying security or securities.

### C. Overview of Comments and Final Rules

The Commission received four letters in response to its request for comment on the proposed rules.<sup>16</sup> Generally, the commenters supported the proposed rules, but

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<sup>14</sup> The proposed rules relating to trading halts for security futures products can be found at 66 FR 45903 (August 30, 2001).

<sup>15</sup> The proposed rules relating to cash settlement for security futures products can be found at 66 FR 45903 (August 30, 2001).

<sup>16</sup> Comments were provided by the Chicago Mercantile Exchange (“CME”) on August 20, 2001, the Chicago Board Options Exchange (“CBOE”) on August 20, 2001, the American Stock Exchange (“AMEX”) on August 31, 2001, and the Intermarket Surveillance Group (“ISG”) on September 10, 2001.

objected to, or offered suggested modifications relating to, several individual provisions or requirements.

Except to the extent discussed below, the Commission will adopt the rules as proposed. The Commission has carefully considered the commenters' views on the proposed rules and has adopted several revisions to the proposed rules consistent with those comments.

**1. Rule 41.21: Securities Eligible to Underlie Security Futures Products**

AMEX suggested that the types of securities underlying security futures products should include exchange-traded funds ("ETFs"), trust issued receipts ("TIRs"), American Depositary Receipts ("ADRs"), and closed-end registered investment companies ("subject securities"). AMEX argued that these products are functionally comparable to common stock in the sense that they represent shares of securities that are registered under Section 12 of the Exchange Act.

The Commission and the SEC agree that ADRs are eligible securities for purposes of rule 41.21 under certain conditions. In this regard, on August 20, 2001, the Commission and the SEC issued a joint order modifying the requirements regarding securities underlying security futures products. In that order, pursuant to the authority provided in Section 2(a)(1)(D)(v) of the CEA and Section 6(h)(4)(A) of the Exchange Act, the Commissions modified the criteria in Section 2(a)(1)(D)(I) and (III) of the CEA and Sections 6(h)(3)(A) and (D) of the Exchange Act regarding the securities eligible for underlying security futures products. The order permits a depositary share, as defined in Exchange Act rule 12b-2,<sup>17</sup> to underlie a security future and be a component of a narrow-

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<sup>17</sup> 17 CFR 240.12b-2.



based security index, provided that two conditions are met: (1) the securities underlying the depositary share are registered pursuant to Section 12 of the Exchange Act and (2) the depositary share is registered under the Securities Act of 1933 on Form F-6.

Regarding ETFs, TIRs, and “subject securities,” the Commission and the SEC will consider separately the AMEX’s request to allow these other securities to underlie security futures products. The Commission and the SEC will also consider what eligibility criteria and listing standards would be appropriate for such other underlying securities. The Commission and the SEC may seek public comment prior to issuing any orders regarding these securities.

Finally, the Commission has clarified the text of rule 41.21 to more clearly state that requirements for listing securities as security futures products relate to the security or securities that underlie security futures contracts.

## **2. Rule 41.22(d): Who May Trade Security Futures Products**

CBOE noted that proposed rule 41.22(d), which lists the persons and entities who may trade or offer security futures products, does not encompass everyone who currently trades on the floor of CBOE; notably, some market makers. The proposed rule provided that only five categories of persons may trade security futures products, “except to the extent otherwise permitted under the Securities Exchange Act of 1934 and the rules and regulations thereunder . . .” The rule was drafted in such a manner because Section 2(a)(1)(D)(i)(V) of the CEA explicitly provides that only futures commission merchants, introducing brokers, commodity trading advisors, commodity pool operators or associated persons subject to suitability rules comparable to those of a national securities association registered pursuant to Section 15A(a) of the Exchange Act may solicit, accept

orders for, or otherwise deal in any transaction in or in connection with security futures products. By including the language “except to the extent otherwise permitted under the Securities Exchange Act of 1934 and the rules and regulations thereunder . . .” the Commission intended to encompass within the rule all persons and entities that are allowed to trade security futures products under the Exchange Act and its rules and regulations.

The Commission notes that brokers and dealers registered with the SEC may notice-register with the Commission to become futures commission merchants or introducing brokers.<sup>18</sup> In addition, it should be noted that associated persons of notice-registered futures commission merchants or introducing brokers are exempt from registration pursuant to Section 4k(5) of the CEA. These persons, however, are presumably permitted to trade security futures products under the Exchange Act, and therefore qualify for certification under rule 41.22(d).

### **3. Rule 41.22(g): Required Membership in the Intermarket Surveillance Group**

Three commenters expressed concern about the provision in proposed rule 41.22(g) that would require boards of trade trading security futures products to be full members of the Intermarket Surveillance Group in order to meet the coordinated surveillance requirement of Section (2)(a)(1)(D)(i)(VIII) of the CEA.<sup>19</sup> The Intermarket Surveillance Group expressed its belief that requiring ISG membership in order to trade

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<sup>18</sup> Section 4f of the CEA, as amended by Section 252(b) of the CFMA, allows brokers and dealers registered with the SEC to register with the Commission as futures commission merchants or introducing brokers so long as they adhere to certain requirements regarding transactions in connection with security futures products. The Commission adopted rules regarding the procedures for brokers or dealers to notice register as a futures commission merchant or introducing broker. See 66 FR 43080 (August 17, 2001).

<sup>19</sup> CME, AMEX and ISG.

security futures products went beyond the requirements of the CFMA, exceeds the Commission's authority, and is potentially anti-competitive. The ISG noted that membership in the ISG is not automatic, and one current member could effectively veto membership by an applicant and thus could preclude trading of security futures products by such interested board of trade. The ISG expressed strong support for a rule that would ensure coordinated surveillance among markets and noted a willingness to work with the Commission in fostering effective surveillance coordination; however, it stated that rule 41.22(g) as proposed was an inappropriate means of achieving coordinated surveillance.

CME also expressed concern that not all boards of trade would be accepted as full members of the ISG, or that they may not be accepted quickly enough so that the boards of trade could commence trading security futures products when allowed to do so under the CFMA. CME suggested that the final rule include a grace period for boards of trade that have affiliate membership status and have applied for full membership and have satisfied the membership criteria applicable to national securities exchanges but have not yet been formally accepted.

AMEX indicated that the CFTC lacked the statutory authority to compel all boards of trade that wish to trade security futures products to be full members of the ISG. Furthermore, AMEX pointed out that a board of trade may only become a member of the ISG with the unanimous approval of all of its members. Thus, membership is not guaranteed, and in any case, the application process may be lengthy.

In light of the foregoing concerns regarding the full ISG membership requirement in proposed rule 41.22(g), the Commission has determined to defer consideration of this matter at this time. The final rule published today simply sets forth the requirement that a

board of trade certify that it has in place procedures for coordinated surveillance. The Commission and the SEC are addressing the appropriate means of ensuring that this statutory requirement is satisfied, and the Commissions will consider whether it is appropriate to publish final rules related to the coordinated surveillance requirement of the CEA and the Exchange Act in a separate joint rulemaking related to trading halts and requirements for cash settlement.<sup>20</sup> All comments received by the Commission regarding membership in the ISG in response to the instant rulemaking will be considered by both agencies in the promulgation of the final joint release. Further, the Commission would welcome additional comment concerning membership in the ISG in response to the joint rule proposal.

**4. Rules 41.22(g), 41.22(h), and 41.22(i): Certifications Required by Alternative Trading Systems**

CBOE raised a point applicable to proposed rules 41.22(g), (h), and (i)—namely, that the exception to the required certifications for the listing standards in these rules should only apply to alternative trading systems that are members of a national securities exchange or national securities association; and that the exception, by the terms of the CEA, should not apply to national securities exchanges or national securities associations themselves.

After considering this comment, the Commission has revised proposed rules 41.22(g), (h), and (i) to clarify what entities are exempt from making the certifications required by those rules, consistent with the language of the CEA and the Exchange Act. The final rules exempt only alternative trading systems from making these three

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<sup>20</sup> See 66 FR 45903.

certifications. Furthermore, the rules are clarified to exempt only those alternative trading systems that are members of either national security exchanges that have the required procedures in place, or national security associations that have the required procedures in place.

**5. Rules 41.22(i) and 41.25(a)(2): Trading Halts**

CBOE stated that proposed rule 41.22(i) should be clarified to explain whether the circuit breakers already in place on boards of trade are sufficient to satisfy the proposed rules regarding trading halts. The Commission notes that proposed rule 41.25(a)(2) was reserved to set forth requirements regarding trading halts. As with requirements related to cash settlement procedures for security futures products, proposed rules related to trading halt requirements were set forth in a separate joint rulemaking by the Commission and the SEC.<sup>21</sup> This CBOE comment will be addressed by the Commission and the SEC in promulgating those final rules.

**6. Rule 41.25(a)(1): Reporting of Data**

AMEX suggested that notice designated contract markets (as opposed to designated contract markets and registered DTEFs) should be exempt from the daily reporting requirements of proposed 41.25(a) if the notice designated contract market files comparable information with the SEC. The Commission routinely collects the information required by Part 16 of the regulations from all futures exchanges, and it intends to do so for all exchanges trading security futures products. The Commission is unaware of any current or planned daily data collection by the Securities and Exchange Commission that is comparable to the data specified in Part 16. However, the

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<sup>21</sup> See 66 FR at 45918.

Commission's market surveillance staff will consider requests by an exchange seeking relief from pertinent parts of these reporting requirements for which data already are available to the Commission or are not useful to the Commission's surveillance program.

**7. Rule 41.25(a)(3): Speculative Position Limit Provisions**

Three commenters commented on the proposed rules regarding the requirements for speculative position limits or position accountability. Two commenters noted that the proposed position limit provisions differ somewhat from the limits imposed on security and securities index options.<sup>22</sup> Differences cited include the specification of limits on a net, rather than a gross, position basis; the establishment of numerical limit levels that differ from those imposed on security and securities index options; and the fact that the proposed limits would apply only during the last five days of trading.

CME suggested that the Commission adopt a position accountability standard for all security futures products and not require that speculative limits be imposed for contracts on less liquid securities, as specified in the proposed rules. CBOE and AMEX did not object to the proposed speculative position limit provisions, but suggested that the Commission coordinate with the SEC so that speculative position limit rules for security and securities index futures products are the same as those applicable for security and securities index options. Barring that, these two commenters recommended that the Commission adopt position limit provisions that more closely resemble existing limits on option index options. In addition, CME and AMEX asked that the term "least liquid" be clarified in connection with applying speculative position limits for narrow-based stock indexes, and that this requirement be linked to the average daily trading volume of the

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<sup>22</sup> CBOE and AMEX.

average security in an index. Finally, CME recommended that the “six months” of calculations specified in the proposed rules should be made no more frequently than once a month.

After careful consideration of the comments, the Commission is adopting the speculative limit provisions as set forth in the proposed rules, with two modifications. In this regard, the Commission is modifying proposed rule 41.25(a)(3) by adding a new paragraph (iv) to clarify how “average daily trading volume” is to be calculated in determining whether speculative position limits are required and if so, the level that is applicable. These changes require calculations to be made monthly and establish procedures for implementing new levels when required, consistent with the suggestions of CME and AMEX. Further, for clarification, the term “least liquid security” in rule 41.25(a)(3)(ii) has been changed to the security with the lowest average daily trading volume.

In regard to CME’s suggestion that the Commission adopt a position accountability standard for all security futures products, the Commission continues to believe that speculative position limits are appropriate for contracts based on securities that are less liquid or less highly capitalized. Allowing position accountability only for contracts that overlie the most liquid and highly capitalized securities is consistent with the Commission’s surveillance experience and its long-standing approach regarding position accountability. Contracts based on less liquid and lower capitalized securities are more susceptible to manipulation or price distortions, and thus, the Commission believes that speculative position limits are appropriate measures to minimize the potential for these abuses.

In regard to the commenters' observations about differences in the proposed security futures product speculative position limits relative to existing security and securities index options limits, the Commission notes that the provisions are consistent with the Commission's customary approach for all other futures markets. As with other markets, the Commission believes that the speculative position limit and position accountability provisions set forth in the proposal are necessary to effectively oversee the markets and are consistent with the obligation in Section 2(a)(1)(D)(i)(VII) of the CEA that a designated contract market or registered DTEF maintain procedures to prevent manipulation of the price of the security futures product and the underlying security or securities.

As the Commission noted in the proposed rulemaking, the Commission's proposed position limit levels were set at levels that are generally comparable but not identical to the limits that currently apply to options on individual securities. The differences mainly reflect certain provisions adopted for commodity futures contracts that reflect the special characteristics of those markets. In this regard, the proposed position limit requirements for security futures differ from individual security option position limit rules in that the limits would apply only to net positions in an expiring security futures contract during its five last trading days. The Commission believes that this provision is appropriate since, consistent with its experience in conducting surveillance of other futures markets, it is during the time period near contract expiration that the potential for manipulation based on an extraordinarily large net futures position would most likely occur.



The Commission also believes that position accountability is appropriate for contracts on highly liquid and capitalized securities. In this regard, for security futures contracts based on a security that has an average daily trading volume greater than 20 million shares, the Commission believes that the threat of manipulation is sufficiently reduced such that an exchange could substitute a position accountability rule in lieu of a fixed position limit. Under such a rule, a trader holding a position in a security future that exceeded a threshold level determined by the exchange (*e.g.*, no more than 22,500 contracts of 100 shares) would agree to provide information to the exchange regarding that position and consent to halt increasing the position if requested by the exchange.

#### **8. Rule 41.25(b): Cash Settlement Price**

CBOE stated that the cash settlement price for security futures products should be based on the underlying securities' opening price. Proposed rule 41.25(b) provided that, "For cash-settled security futures products, the cash-settlement price must be reliable and acceptable, be reflective of prices in the underlying securities market and be not readily susceptible to manipulation." Part of proposed rule 41.25(b) was reserved for specific rules regarding acceptable practices for the calculation of cash settlement prices. In a separate rulemaking issued jointly with the SEC, the Commission proposed that cash settlement be based on opening prices, consistent with the CBOE comment.<sup>23</sup> Accordingly, the Commission and the SEC will address CBOE's comment in the final rulemaking for that proposal. The Commission notes that one line of text has been removed from proposed rule 41.25(b), due to changes made to the text of that proposed rule in the joint rulemaking. This change is not substantive.

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<sup>23</sup> See 66 FR at 45918 – 19.

## **9. Applicability of Rules to Notice-Registered Entities**

CBOE requested clarification as to whether the proposed rules applied to all boards of trade, including those that are notice-registered with the Commission. The Commission recently issued final rules regarding notice procedures for national securities exchanges, national securities associations, and alternative trading systems to become a designated contract market in security futures products.<sup>24</sup> In accordance with those rules and with Section 5f of the CEA, any board of trade that registers with the Commission as a notice designated contract market is, by definition, a designated contract market. Hence, the rules adopted today apply to designated contract markets under Section 5 of the CEA, registered DTEFs under Section 5a of the CEA, and notice designated contract markets under Section 5f of the CEA. It should be noted, however, that notice designated contract markets are exempt from certain provisions of the CEA in accordance with Section 5f(b)(1) of the CEA. The final rules, therefore, apply to all boards of trade that trade security futures products, except where otherwise explicitly noted in the rules.

## **II. ADMINISTRATIVE PROCEDURE ACT**

The Administrative Procedure Act (the “APA”) generally requires that rules promulgated by an agency not be made effective less than thirty days after publication, except for, among other things, instances where the agency finds good cause to make a rule effective sooner, and has published that finding together with the rule.<sup>25</sup> Pursuant to the CFMA, beginning on August 21, 2001, eligible contract participants may trade security futures products on a principal-to-principal basis. The rules being published

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<sup>24</sup> See 66 FR 44960 (August 27, 2001).

today affect the products that eligible contract participants may trade on a designated contract market or registered DTEF. The CFTC believes good cause exists for the rules to become effective immediately, so that boards of trade can list security futures products for trading by eligible contract participants, as contemplated by the CFMA. Furthermore, to the extent that these rules have been promulgated in substantially the same form as the proposed rules, any affected boards of trade are already familiar with the rules.

Therefore, the Commission concludes that there is good cause for making these rules effective immediately upon publication.

### **III. COSTS AND BENEFITS OF THE RULES**

Section 15 of the CEA requires the Commission to consider the costs and benefits of its action before issuing a new regulation.<sup>26</sup> The Commission understands that, by its terms, Section 15 does not require the Commission 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 simply requires the Commission to “consider the costs and benefits” of its action.

Section 15 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 Commission could in its discretion give greater weight to any one of the

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<sup>25</sup> 5 U.S.C. 553(d)(3).

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 CEA.

These rules constitute one part of a package of related rule provisions. The rules provide guidance and establish procedures for trading facilities to comply with governing laws related to security futures products. The Commission considered the costs and benefits of these rules, in light of the specific areas of concern identified in Section 15.<sup>27</sup> The 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 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.

The Commission solicited comments about its consideration of these costs and benefits.<sup>28</sup> The Commission received no comments. Accordingly, the Commission has determined to adopt the regulations discussed above. Changes made to the proposed rules as a result of the comments do not affect the Commission's consideration of the costs and benefits of this rulemaking.

#### **IV. RELATED MATTERS**

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<sup>26</sup> 7 U.S.C. 19.

<sup>27</sup> 66 FR at 37936.

<sup>28</sup> 66 FR at 37936.

A. Paperwork Reduction Act

The Paperwork Reduction Act (“PRA”) of 1995, 44 U.S.C. 3501 et seq., imposes certain requirements on federal agencies (including the Commission) in connection with their conducting or sponsoring any collection of information as defined by the PRA. This rulemaking contains information collection requirements within the meaning of the PRA. The Commission submitted a copy of this part to the Office of Management and Budget (OMB) for its review in accordance with 44 U.S.C. 3507(d).

Collection of Information: Part 41, Relating to Security Futures Products, OMB Control Number 3038-0059.

No comments were received in response to the Commission’s invitation in the notice of proposed rulemaking to comment on any paperwork burden associated with these rules.<sup>29</sup> See 44 U.S.C. 3507(d)(2).

Copies of the information collection submission to OMB are available from the Commission from the CFTC Clearance Officer, 1155 21<sup>st</sup> Street, NW, Washington, DC 20581, (202) 418-5160.

B. Regulatory Flexibility Act

The Regulatory Flexibility Act (“RFA”), 5 U.S.C. 601 et seq., requires federal agencies, in promulgating rules, to consider the impact of those rules on small entities. The rules adopted herein would affect contract markets, registered DTEFs, and derivatives clearing organizations. The Commission previously established certain definitions of “small entities” to be used by the Commission in evaluating the impact of its rules on small entities in accordance with the RFA. In its previous determinations, the

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<sup>29</sup> 66 FR at 37936.

Commission concluded that contract markets, registered derivatives trading execution facilities, and derivatives clearing organizations are not small entities for the purpose of the RFA.<sup>30</sup> In the proposed rulemaking, the Chairman certified that these rules would not have a significant economic impact on a substantial number of small entities.<sup>31</sup> The Commission invited comment on this determination, but received no comments.

## V. STATUTORY AUTHORITY

The Commission has the authority to propose these rules pursuant to Sections 1a, 2(a)(1)(D), and 5c(c) of the CEA, 7 U.S.C. 1a, 2(a)(1)(D), and 7a-2(c).

### List of Subjects in 17 CFR Part 41

Security futures products

### Text of Proposed Rules

In accordance with the foregoing, Title 17, chapter 1 of the Code of Federal Regulations is amended as follows:

### Part 41—SECURITY FUTURES PRODUCTS

1. The authority citation for Part 41 continues to read as follows:

**Authority:** Sections 251 and 252, Pub. L. 106-554, 114 Stat. 2763; 7 U.S.C. 1a, 2, 6f, 6j, 7a-2, 12a.

2. Subpart C is added to read as follows:

### Subpart C—Requirements and Standards for Security Futures Products

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<sup>30</sup> See 47 FR 18618, 18619 (April 30, 1982) (contract markets); 66 FR 42256, 42268 (August 10, 2001) (registered derivatives trading execution facilities); 66 FR 45604, 45609 (August 29, 2001) (derivatives clearing organizations).

<sup>31</sup> See 5 U.S.C. 605(b).

**41.21 Requirements for underlying securities****41.22 Required certifications****41.23 Listing of security futures products for trading****41.24 Rule amendments to security futures products****41.25 Additional conditions for trading security futures products****Subpart C—Requirements and Standards for Listing Security Futures products****§ 41.21 Requirements for underlying securities**

(a) **Security futures products based on a single security.** A futures contract on a single security is eligible to be traded as a security futures product only if:

- (1) The underlying security is registered pursuant to Section 12 of the Securities Exchange Act of 1934;
- (2) The underlying security is:
  - (i) Common stock, or
  - (ii) Such other equity security as the Commission and the SEC jointly deem appropriate; and,
- (3) The underlying security conforms with the listing standards for the security futures product that the designated contract market or registered derivatives transaction execution facility has filed with the SEC under Section 19(b) of the Securities Exchange Act of 1934.

(b) **Security futures product based on two or more securities.** A futures contract on an index of two or more securities is eligible to be traded as a security futures product only if:

(1) The index is a narrow-based security index as defined in Section 1a(25) of the Act;

(2) The securities in the index are registered pursuant to Section 12 of the Securities Exchange Act of 1934;

(3) The securities in the index are:

(i) Common stock, or

(ii) Such other equity securities as the Commission and the SEC jointly deem appropriate; and,

(4) The index conforms with the listing standards for the security futures product that the designated contract market or registered derivatives transaction execution facility has filed with the SEC under Section 19(b) of the Securities Exchange Act of 1934.

#### **§ 41.22 Required certifications**

It shall be unlawful for a designated contract market or registered derivatives transaction execution facility to list for trading or execution a security futures product unless the designated contract market or registered derivatives transaction execution facility has provided the Commission with a certification that the specific security futures product or products and the designated contract market or registered derivatives transaction execution facility meet, as applicable, the following criteria:

(a) The underlying security or securities satisfy the requirements of §41.21;

(b) If the security futures product is not cash settled, arrangements are in place with a clearing agency registered pursuant to Section 17A of the Securities Exchange Act



of 1934 for the payment and delivery of the securities underlying the security futures product;

(c) [Reserved for common clearing following compliance date];

(d) Only futures commission merchants, introducing brokers, commodity trading advisors, commodity pool operators or associated persons subject to suitability rules comparable to those of a national securities association registered pursuant to Section 15A(a) of the Securities Exchange Act of 1934 and the rules and regulations thereunder, except to the extent otherwise permitted under the Securities Exchange Act of 1934 and the rules and regulations thereunder, may solicit, accept any order for, or otherwise deal in any transaction in or in connection with security futures products;

(e) If the board of trade is a designated contract market pursuant to Section 5 of the Act or is a registered derivatives transaction execution facility pursuant to Section 5a of the Act, dual trading in these security futures products is restricted in accordance with §41.27;

(f) Trading in the security futures products is not readily susceptible to manipulation of the price of such security futures product, nor to causing or being used in the manipulation of the price of any underlying security, option on such security, or option on a group or index including such securities, consistent with the conditions for trading of §41.25;

(g) Procedures are in place for coordinated surveillance among the board of trade, any market on which any security underlying a security futures product is traded, and other markets on which any related security is traded to detect manipulation and

insider trading. A board of trade that is an alternative trading system does not need to make this certification, provided that:

(1) The alternative trading system is a member of a national securities association registered pursuant to Section 15A(a) of the Securities Exchange Act of 1934 or national securities exchange registered pursuant to Section 6(a) of the Securities Exchange Act of 1934; and

(2) The national securities association or national securities exchange of which the alternative trading system is a member has in place such procedures;

(h) An audit trail is in place to facilitate coordinated surveillance among the board of trade, any market on which any security underlying a security futures product is traded, and any market on which any related security is traded. A board of trade that is an alternative trading system does not need to make this certification, provided that:

(1) The alternative trading system is a member of a national securities association registered pursuant to Section 15A(a) of the Securities Exchange Act of 1934 or national securities exchange registered pursuant to Section 6(a) of the Securities Exchange Act of 1934; and

(2) The national securities association or national securities exchange of which the alternative trading system is a member has in place such procedures;

(i) Procedures are in place to coordinate regulatory trading halts between the board of trade and markets on which any security underlying the security futures product is traded and other markets on which any related security is traded. A board of trade that is an alternative trading system does not need to make this certification, provided that:

(1) The alternative trading system is a member of a national securities association registered pursuant to Section 15A(a) of the Securities Exchange Act of 1934 or national securities exchange registered pursuant to Section 6(a) of the Securities Exchange Act of 1934; and

(2) The national securities association or national securities exchange of which the alternative trading system is a member has in place such procedures; and

(j) The margin requirements for the security futures product will comply with the provisions specified in §41.43 through §41.48.

#### **§ 41.23 Listing of security futures products for trading**

(a) **Initial listing of products for trading.** To list new security futures products for trading, a designated contract market or registered derivatives transaction execution facility shall submit to the Commission at its Washington, D.C. headquarters, either in electronic or hard-copy form, to be received by the Commission no later than the day prior to the initiation of trading, a filing that:

(1) Is labeled “Listing of Security Futures Product;”

(2) Includes a copy of the product's rules, including its terms and conditions;

(3) Includes the certifications required by §41.22;

(4) Includes a certification that the terms and conditions of the contract

comply with the additional conditions for trading of §41.25; and

(5) If the board of trade is a designated contract market pursuant to Section 5 of the Act or a registered derivatives transaction execution facility pursuant to Section 5a

of the Act, it includes a certification that the security futures product complies with the Act and rules thereunder.

(b) **Voluntary submission of security futures products for Commission approval.** A designated contract market or registered derivatives transaction execution facility may request that the Commission approve any security futures product under the procedures of §40.5 of this chapter, provided however that the registered entity shall include the certification required by §41.22 with its submission under §40.5 of this chapter. Notice designated contract markets may not request Commission approval of security futures products.

#### **§ 41.24 Rule amendments to security futures products**

(a) **Self-certification of rules and rule amendments by designated contract markets and registered derivatives clearing organizations.** A designated contract market or registered derivatives clearing organization may implement any new rule or rule amendment relating to a security futures product by submitting to the Commission at its Washington, D.C. headquarters, either in electronic or hard-copy form, to be received by the Commission no later than the day prior to the implementation of the rule or rule amendment, a filing that:

- (1) Is labeled “Security Futures Product Rule Submission;”
- (2) Includes a copy of the new rule or rule amendment;
- (3) Includes a certification that the designated contract market or registered derivatives clearing organization has filed the rule or rule amendment with the Securities and Exchange Commission, if such a filing is required; and

(4) If the board of trade is a designated contract market pursuant to Section 5 of the Act or is a registered derivatives clearing organization pursuant to Section 5b of the Act, it includes the documents and certifications required to be filed with the Commission pursuant to §40.6 of this chapter, including a certification that the security futures product complies with the Act and rules thereunder.

(b) **Self-certification of rules by registered derivatives transaction execution facilities.** Notwithstanding §37.7 of this chapter, a registered derivatives transaction execution facility may only implement a new rule or rule amendment relating to a security futures product if the registered derivatives transaction execution facility has certified the rule or rule amendment pursuant to the procedures of paragraph (a) of this section.

(c) **Voluntary submission of rules for Commission review and approval.** A designated contract market, registered derivatives transaction execution facility, or a registered derivatives clearing organization clearing security futures products may request that the Commission approve any rule or proposed rule or rule amendment relating to a security futures product under the procedures of §40.5 of this chapter, provided however that the registered entity shall include the certifications required by §41.22 with its submission under §40.5 of this chapter. Notice designated contract markets may not request Commission approval of rules.

#### **§ 41.25 Additional conditions for trading for security futures products**

(a) **Common Provisions.**

(1) Reporting of Data. The designated contract market or registered derivatives transaction execution facility shall comply with chapter 16 of this title requiring the daily reporting of market data.

(2) Regulatory Trading Halts. [Reserved.]

(3) Speculative Position Limits. The designated contract market or registered derivatives transaction execution facility shall have rules in place establishing position limits or position accountability procedures for the expiring futures contract month. The designated contract market or registered derivatives transaction execution facility shall,

(i) Adopt a net position limit no greater than 13,500 (100-share) contracts applicable to positions held during the last five trading days of an expiring contract month; except where,

(A) For security futures products where the average daily trading volume in the underlying security exceeds 20 million shares, or exceeds 15 million shares and there are more than 40 million shares of the underlying security outstanding, the designated contract market or registered derivatives transaction execution facility may adopt a net position limit no greater than 22,500 (100-share) contracts applicable to positions held during the last five trading days of an expiring contract month; or

(B) For security futures products where the average daily trading volume in the underlying security exceeds 20 million shares and there are more than 40 million shares of the underlying security outstanding, the designated contract market or registered derivatives transaction execution facility may adopt a position accountability rule. Upon request by the designated contract market or registered derivatives transaction execution facility, traders who hold net positions greater than 22,500 (100-share) contracts, or such

lower level specified by exchange rules, must provide information to the exchange and consent to halt increasing their positions when so ordered by the exchange.

(ii) For a security futures product comprised of more than one security, the criteria in paragraphs (a)(3)(i)(A) and (a)(3)(i)(B) of this section must apply to the security in the index with the lowest average daily trading volume.

(iii) Exchanges may approve exemptions from these position limits pursuant to rules that are consistent with §150.3 of this chapter.

(iv) For purposes of this section, average daily trading volume shall be calculated monthly, using data for the most recent six-month period. If the data justify a higher or lower speculative limit for a security future, the designated contract market or registered derivatives transaction execution facility may raise or lower the position limit for that security future effective no earlier than the day after it has provided notification to the Commission and to the public under the submission requirements of §41.24. If the data require imposition of a reduced position limit for a security future, the designated contract market or registered derivatives transaction execution facility may permit any trader holding a position in compliance with the previous position limit, but in excess of the reduced limit, to maintain such position through the expiration of the security futures contract; provided that the designated contract market or registered derivatives transaction execution facility does not find that the position poses a threat to the orderly expiration of such contract.

(b) **Special requirements for cash-settled contracts.** For cash-settled security futures products, the cash-settlement price must be reliable and acceptable, be

reflective of prices in the underlying securities market and be not readily susceptible to manipulation.

[Reserved.]

(c) **Special requirements for physical delivery contracts.** For security futures products settled by actual delivery of the underlying security or securities, payment and delivery of the underlying security or securities must be effected through a clearing agency that is registered pursuant to Section 17A of the Securities Exchange Act of 1934.

Issued in Washington, D.C., on October 25, 2001, by the Commission.

Jean A. Webb,  
Secretary