COMMODITY FUTURES TRADING COMMISSION

SECURITIES AND EXCHANGE COMMISSION

[Release No. 34–49469]

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

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

ACTION: Joint order.

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

EFFECTIVE DATE: March 25, 2004.

FOR FURTHER INFORMATION CONTACT:

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SEC: Elizabeth K. King, Associate Director, at (202) 942–0140, or Theodore R. Lazo, Senior Special Counsel, at (202) 942–0745, Division of Market Regulation, Securities and Exchange Commission, 450 Fifth Street, NW., Washington, DC 20549–1001.

SUPPLEMENTARY INFORMATION:

I. Background

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

Section 1a(25) of the CEA[3] and section 3(a)(55)(B) of the Exchange Act[4] provide that an index is a ''narrow-based security index'' if, among other things, it meets one of the following four criteria:

(i) The index has nine or fewer component securities;

(ii) Any component security of the index comprises more than 30 percent of the index's weighting;

(iii) The five highest weighted component securities of the index in the aggregate comprise more than 60 percent of the index's weighting; or

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

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

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

In September 2003, CBOE Futures Exchange, LLC (''CFE''), a designated contract market approved by the CFTC, announced plans to trade futures contracts on certain ''volatility indexes'' created by the Chicago Board Options Exchange, Inc. (''CBOE'').[6] Each of these volatility indexes is designed to measure the variability of daily returns on a security index (''Underlying Broad-Based Security Index''), as reflected in the prices of options on the Underlying Broad-Based Security Index. Accordingly, the component securities of a volatility index are put and call options on a security index.[7] In light of CFE's announcement, the Commissions have considered whether volatility indexes are narrow-based security indexes.

II. Discussion

The statutory definition of the term narrow-based security index is designed to distinguish among indexes comprised of individual stocks. As a result, certain aspects of that definition are designed to take into account the trading patterns of individual stocks rather than those of other types of exchange-traded securities, such as options. However, the Commissions believe that the definition is not limited to indexes on individual stocks. In fact, section 1a(25)(B)(vi) of the CEA and section 3(a)(55)(C)(vi) of the Exchange Act give the Commissions joint authority to make determinations with respect to security indexes that do not meet the specific statutory criteria without regard to the types of securities that comprise the index.

Subject to the conditions set forth below, the Commissions believe that it is appropriate to exclude certain indexes comprised of options on broad-based security indexes from the definition of the term narrow-based security index. An index must satisfy all of the following conditions to qualify for the exclusion.

The first condition limits the exclusion to indexes that measure

[1] *See* section 1a(31) of the CEA and section 3(a)(55)(A) of the Exchange Act, 7 U.S.C. 1a(31) and 15 U.S.C. 78c(a)(55)(A).

[2] *See* 17 CFR 41.1(c).

[3] 7 U.S.C. 1a(25).

[4] 15 U.S.C. 78c(a)(55)(B).

[5] *See, e.g., Joint Order Excluding from the Definition of Narrow-Based Security Index those Security Indexes that Qualified for the Exclusion from that Definition under Section 1a(25)(B)(v) of the Commodity Exchange Act and Section 3(a)(55)(C)(v) of the Securities Exchange Act of 1934* (May 31, 2002), 67 FR 38941 (June 6, 2002).

[6] *See* CBOE News Release, ''CBOE Announces Launch of Futures on VIX: First Tradable Volatility Product Will be Offered on New CBOE Futures Exchange'' (September 5, 2003). The news release is available at *www.cboe.com*.

[7] CBOE has published a White Paper describing the calculation and methodology of its volatility indexes, which is available at *www.cboe.com/micro/vix/vixwhite.pdf*.

changes in the level of an Underlying Broad-Based Security Index over a period of time using the standard deviation or variance of price changes in options on the Underlying Broad-Based Security Index. The Commissions believe this condition is necessary to limit the exclusion to indexes calculated using one of two commonly recognized statistical measurements that show the degree to which an individual value tends to vary from an average value. The second, third, and fourth conditions provide that the exclusion applies to indexes that qualify as broad-based security indexes under the statutory criteria that evaluate the composition and weighting of the securities comprising an index. The fifth condition provides that the exclusion applies only if the Underlying Broad-Based Security Index qualifies as a broad-based security index under the statutory criterion that evaluates the liquidity of the securities comprising an index. The Commissions believe at this time that this condition is appropriate so that any such Underlying Broad-Based Security Index, including those that are not narrow-based under any of the exclusions to the definition under sections 1(a)(25)(B) of the CEA and 3(a)(55)(C) of the Exchange Act, meets the statutory liquidity criterion. The sixth condition provides that the exclusion applies if the options comprising the index are listed and traded on a national securities exchange. Given the novelty of volatility indexes, the Commissions believe at this time that it is appropriate to limit the component securities to those index options that are listed for trading on a national securities exchange where the Commissions know pricing information is current, accurate and publicly available. Finally, the seventh condition provides that the exclusion applies only if the options comprising the index have an aggregate average daily trading volume of 10,000 contracts. The Commissions believe that this condition limits the exclusion to indexes for which there is a liquid market on a national securities exchange for the options on the Underlying Broad-Based Security Index, which contributes to the Commissions' view that futures on such indexes should not be readily susceptible to manipulation.

The Commissions believe that indexes satisfying these conditions are appropriately classified as broad based because they measure the magnitude of changes in the level of an underlying index that is a broad-based security index. In addition, the Commissions believe that futures contracts on indexes that satisfy the conditions of this exclusion should not be readily susceptible to manipulation because of the composition, weighting, and liquidity of the securities in the Underlying Broad-Based Security Index and the liquidity that the options comprising the index must have to qualify for the exclusion. Specifically, these factors should substantially reduce the ability to manipulate the price of a future on an index satisfying the conditions of the exclusion using the options comprising the index or the securities comprising the Underlying Broad-Based Security Index.

Accordingly,

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

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

(2) The index has more than nine component securities, all of which are options on the Underlying Broad-Based Security Index;

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

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

(5) The average daily trading volume of the lowest weighted component securities in the Underlying Broad-Based Security Index upon which the index is calculated (those comprising, in the aggregate, 25% of the Underlying Broad-Based Security Index's weighting) has a dollar value of more than $50,000,000 (or $30,000,000 in the case of a Underlying Broad-Based Security Index with 15 or more component securities), except if there are two or more securities with equal weighting that could be included in the calculation of the lowest weighted component securities comprising, in the aggregate, 25% of the Underlying Broad-Based Security Index's weighting, such securities shall be ranked from lowest to highest dollar value of average daily trading volume and shall be included in the calculation based on their ranking starting with the lowest ranked security;

(6) Options on the Underlying Broad-Based Security Index are listed and traded on a national securities exchange registered under section 6(a) of the Exchange Act; and

(7) The aggregate average daily trading volume in options on the Underlying Broad-Based Security Index is at least 10,000 contracts calculated as of the preceding 6 full calendar months.

By the Commodity Futures Trading Commission.

Dated: March 25, 2004.

Jean Webb,

Secretary.

By the Securities and Exchange Commission.

Dated: March 25, 2004.

Margaret H. McFarland,

Deputy Secretary.

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DEPARTMENT OF DEFENSE

Department of the Army

Army Educational Advisory Committee

AGENCY: Department of the Army, DoD.

ACTION: Notice of open meeting.

SUMMARY: In accordance with Section 10(a)(2) of the Federal Advisory Committee Act (5 U.S.C. App. I), announcement is made of the following committee meeting:

Name of Committee: U.S. Army War College Subcommittee of the Army Education Advisory Committee.

Dates of Meeting: April 29, 2004 and April 30, 2004.

Place of Meeting: Command Conference Room, Root Hall, U.S. Army War College, 122 Forbes Avenue, Carlisle Barracks, Pennsylvania.

Time of Meeting: 8:30 a.m.–5 p.m.

Proposed Agenda: Receive information briefings; conduct discussions with the Commandant and staff and faculty; table and examine online College issues; assess resident and distance education programs, self-study techniques, assemble a working group for the concentrated review of institutional policies and a working group to address committee membership and charter issues; propose