

SECURITIES LITIGATION & REGULATION

EXPERT ANALYSIS

CFTC/SEC Jurisdictional Battle Heats Up Over Dividend Indices

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The CFTC recently approved a futures contract on a dividend index as a non-security based index futures contract over the SEC's objection that the dividend index contract could be a security future; the CFTC's actions may have implications for market participants in this and other dividend index futures contracts and swaps.

On July 22, the US Commodity Futures Trading Commission (CFTC) issued a conditional order approving a proposed listing by the Chicago Mercantile Exchange (CME) of a futures contract (Index Contract) on the S&P 500 Dividend Index (Dividend Index).¹

In approving the listing of the Index Contract as a futures contract, the CFTC determined that the Dividend Index is not a security-based index, but rather an "excluded commodity"² subject to the CFTC's exclusive jurisdiction.

The CFTC made this determination notwithstanding a comment letter filed by the staff of the US Securities and Exchange Commission (SEC) raising "substantial" legal and policy concerns over whether the product should be instead categorized as a security future subject to the joint jurisdiction of both agencies.³

As explained below, while the CFTC's action may clarify its position with respect to dividend index products, the fact that it acted without the concurrence of the SEC could have implications for a variety of market participants that wish to trade in dividend index futures or swaps.

DIVIDEND INDEX

As explained in the CFTC Order, the Dividend Index represents the accrued ex-dividend amounts associated with all the component companies of the S&P 500 cumulated over the course of a specific quarterly accrual period.

At any given point, the Dividend Index represents a running total of dividends, through their ex-dividend dates, associated with all the stocks in the S&P 500.

The Dividend Index is calculated through a bottom-up approach whereby a running total of the dividends paid by the component companies during the quarter is continuously calculated.

The cumulative dividends for the S&P 500 are then converted into index points, which represent the dividend index levels.

The issue in contention between the CFTC and the SEC is whether the Dividend Index is a security future (and in particular, a narrow-based security index as defined by the amendments to the federal securities and commodities laws made by the Commodity Futures Modernization Act of 2000 (CFMA)⁴) or a non-security based index futures contract.

Under the CFMA, the SEC and CFTC have joint jurisdiction over security futures products. The effect of the CFTC Order is to exclude the SEC from having the oversight role over the Dividend Index that it would otherwise have if the Index Contract was considered a security future.

REGULATION OF SECURITY FUTURES

The CFMA eliminated a long-standing prohibition against the trading of security futures products by US investors and gave the SEC and the CFTC joint jurisdiction over such products. The Securities Exchange Act of 1934 (Exchange Act) and the Commodity Exchange Act (CEA) each define a "security future"⁵ to mean, in relevant part, "a contract of sale for future delivery of a single security or of a narrow-based security index, including any interest therein or based on the value thereof."⁶

Because a security future is both a security and a future, securities exchanges and boards of trades that list and trade security futures products, and persons that facilitate transactions in security future products, are subject to the joint jurisdiction of the CFTC and the SEC.⁷

Of particular relevance in connection with the Index Contract are the changes that the CFMA made to the statutes under the SEC's jurisdiction. The CFMA added Section 6(h) to the Exchange Act which, among other things, (1) makes it unlawful for *any* person to effect transactions in security futures products that are not listed on a national securities exchange or a national securities association registered under Section 15A(a) of the Exchange Act;⁸ and (2) generally requires that security futures products conform with listing standards that are filed with the SEC and that meet criteria specified in Section 2(a)(1)(D)(i) of the CEA.⁹

In addition, the CFMA added Section 3(a)(14) of the Securities Act, which exempts security futures products from the requirements of that Act, including Section 5, which generally requires that securities be registered with the SEC to be sold.

This exemption, however, is conditioned on the security future product being (i) cleared by a clearing agency registered under Section 17A of the Exchange Act or exempt from registration under Exchange Act Section 17A(b)(7) and (ii) traded on a national securities exchange or a registered national securities association.

CFTC ORDER AND SEC OBJECTIONS

In approving the Index Contract under Section 5c(c)(4) of the CEA, the CFTC stated that the Dividend Index is an excluded commodity as defined in Section 1a(19) of CEA because it is an "economic or commercial index based on ... values or levels that are not within the control of any party to the relevant contract, agreement or transaction,"¹⁰ or, in the alternative, is an "occurrence, extent of an occurrence, or contingency ... that is beyond the control of the parties to the relevant contract, agreement, or transaction and is associated with a financial, commercial, or economic consequence."¹¹

Based on this reasoning, the CFTC took the position that the Dividend Index is not a security or security index and is under its exclusive jurisdiction.

In its comment letter to the CFTC regarding the Index Contract, the SEC stated that there was a reasonable basis for taking the view that the Index Contract is a security future subject to the joint jurisdiction of the agencies.

The SEC stated that, because the definition of a security future is contained in statutes that are separately administered by the CFTC and the SEC, neither agency has a final say on whether a product is a security future.

The SEC Letter then alluded to discussions between the staff of both agencies on how to analyze whether a future on a dividend index would be viewed as a narrow-based security index and thus a security future under the joint jurisdiction of both agencies.

In support of its view that the Index Contract should be under the jurisdiction of both agencies, the SEC highlighted that the definition of a security future includes the concept of “any interest therein or based on the value thereof” relating to a security or a narrow-based index of securities.

The SEC then cited to a 2009 order under which it stated that “[t]he concept of an ‘interest therein’ in a security plainly includes rights generating a pecuniary interest in a security, such as the right to a dividend payout or bond (coupon) payment.”¹²

The SEC Letter goes on to state that the 2009 SEC Order found that “options on the value of dividends declared by issuers of component securities of a group or index of securities are options on an interest in, or based on the value of an interest in, that group or index of securities.”¹³

The SEC Letter then stated that the Index Contract could be viewed as satisfying all of the components in the definition of a narrow-based security index, and that there is a reasonable basis for taking the view that the Index Contract is a security future.

It is worth highlighting, however, that while the SEC Letter takes a particularly forceful position, it was sent by the staff and not the SEC as an administrative body.

While the SEC, as an administrative body, could take a different view than that expressed by the staff, it is unlikely that the various SEC commissioners were not aware that the staff would be sending the letter.

Notably (and consistent with the position taken in the CFTC Order), CFTC staff submitted a comment letter to the SEC in connection with the 2009 SEC Order where it argued, among other things, that the Dividend Index was more akin to an event contract rather than a securities index.¹⁴

IMPLICATIONS

The CFTC’s decision to approve the Index Contract over the SEC staff’s objections will raise a number of uncertainties for market participants, as well as raising questions as to the SEC’s authority over security-based swaps.

As an initial matter, because the SEC staff may view futures contracts on dividend indexes as security futures, the SEC may potentially view the listing of such contracts by a Futures Exchange that is not notice registered with the SEC as a violation of Section 6 of the Exchange Act, which requires securities exchanges to register with the SEC.

Further, to the extent that persons transact in security futures products on a Futures Exchange that is not also registered with the SEC as a securities exchange (whether fully or through the notice provisions of Exchange Act Section 6(g)), such persons could potentially face liability under Section 6(h)(1) of the Exchange Act.

As mentioned above, that section makes it unlawful for *any person* to transact in security futures products unless such products are traded on a national securities exchange or national securities association.

In addition to liability under Exchange Act Section 6(h)(1), persons that transact in futures contracts on dividend indexes that the SEC deems to be security futures could also face liability under Section 5 of the Securities Act because the exemption from registration for security future products only extends to those that are traded on a securities exchange or securities association.¹⁵

Additionally, FCMs that are not registered as broker-dealers with the SEC (whether fully or through the notice provisions) could face liability for acting as unregistered broker-dealers when effecting transactions in such products if the SEC took the view that the Index Contracts should be regulated as security futures.

Although the CME is notice-registered as a securities exchange, it is possible that the SEC could argue that the listing of the Index Contract would violate Exchange Act Section 6(h)(2) (which requires that security futures products conform to listing standards as approved by the SEC).

Further, the SEC could also take the aggressive view that the CME's notice registration as a securities exchange is ineffective as to the Index Contract.

The views expressed in the CFTC Order also have implications for the jurisdictional allocation between the CFTC and SEC over swaps and security-based swaps.

Title VII of the Dodd-Frank Act¹⁶ (Title VII) created a comprehensive framework for the regulation of swaps and security-based swaps.

Among other things, Title VII created a split approach to the treatment of swaps and security-based swaps, giving the CFTC jurisdiction over swaps and the SEC jurisdiction over security-based swaps.

A security-based swap is defined in Section 3(a)(68) of the Exchange Act as any agreement, contract, or transactions that is as a swap (as defined in Section 1a(47) of the CEA) and is based on, in relevant part, "an index that is a narrow-based security index, *including an interest therein or on the value thereof*" (emphasis added).

Although the CFTC and the SEC provided additional guidance in 2012 regarding the definitions of swap and security-based swap, as well as the meaning of a narrow-based security index, they did not specifically address dividend indices.¹⁷

To the extent that the CFTC applies its views regarding dividend indices to swaps, there will be implications regarding the regulatory status of swaps on dividend indexes, and whether such swaps are CFTC regulated swaps or are SEC regulated securities based swaps.

Thus, concerns over regulatory uncertainty similar to those for Future Exchange, intermediaries, and market participants in the context of the Index Contracts are also present for swaps markets, swaps intermediaries, and swap market participants in the context of swaps on a Dividend Index.

Finally, the CFTC position has potential implications for registered investment companies (RICs) under the 1940 Act because the definition of a "security" under Section 2(a)(36) of that Act includes a "security future," and the CFTC is now characterizing at least some dividend indices as not being security-based indices (and therefore not security futures, and thus not securities).

It is unclear whether the CFTC's position regarding dividend indices will give rise to tax issues for RICs under Subchapter M of the Internal Revenue Code.

In this regard, RICs may want to consult with experienced 1940 Act counsel and tax counsel when transacting in particular Dividend Index products.

CONCLUSION

While the courts (or Congress) may ultimately have to decide whether the Index Contract and other futures contracts on a dividend index is a security future, in the interim, market participants need to weigh the degree of comfort from and level of regulatory uncertainty surrounding the CFTC Order and its implications.

Until there is greater clarity on the SEC's potential actions with respect to the Index Contract and other dividend index contracts, market participants may want to exercise caution when entering into futures contracts on dividend indexes or entering into swap contracts on such products.

NOTES

¹ CFTC, Order Approving the Listing of the Chicago Mercantile Exchange's S&P 500 Dividend Index Futures Contract (July 22, 2015) (CFTC Order) available at cftc.gov/groups/public/@otherif/documents/iftocs/ProdCMEApprovalOrdrDividx_1507.pdf.

² Section 1a(19) of the CEA defines an excluded commodity as "(i) an interest rate, exchange rate, currency, security, security index, credit risk or measure, debt or equity instrument, index or measure of inflation, or other macroeconomic index or measure; (ii) any other rate, differential, index, or measure of economic or commercial risk, return, or value that is (I) not based in substantial part on the value of a narrow group of commodities not described in clause (i); or (II) based solely on 1 or more commodities that have no cash market; (iii) any economic or commercial index based on prices, rates, values, or levels that are not within the control of any party to the relevant contract, agreement, or transaction; or (iv) an occurrence, extent of an occurrence, or contingency (other than a change in the price, rate, value, or level of a commodity not described in clause (i) that is (I) beyond the control of the parties to the relevant contract, agreement, or transaction; and (II) associated with a financial, commercial, or economic consequence."

³ See letter from Brian A. Bussey, Associate Director, Division of Trading and Markets and David R. Fredrickson, Associate Director and Chief Counsel, Division of Corporation Finance, SEC to Christopher Kirkpatrick, Secretary, CFTC, dated July 2, 2015 (SEC Letter), available at cftc.gov/groups/public/@otherif/documents/iftocs/ProdCMECommentLetter_150702.pdf. The letter states that the views expressed are only those of the undersigned divisions and not the views of the SEC or any other division or office within the SEC.

⁴ Public Law 106-554, 114 Stat. 2763 (2000).

⁵ See Section 3(a)(55)(A) of the Exchange Act and Section 1a(44) CEA. Section 2(a)(16) of the Securities Act of 1933 (Securities Act), Section 2(a)(52) of the Investment Company Act of 1940 (1940 Act) and Section 202(a)(27) of the Investment Advisers Act of 1940 (Advisers Act) define a security future by cross reference to Section 3(a)(55) of the Exchange Act. A security futures products is defined as a security future or any put, call, straddle, option, or privilege on any security future. See Exchange Act Section 3(a)(56).

⁶ The Exchange Act and the CEA further define a "narrow-based security index" to "mean an index (i) that has 9 or fewer components; (ii) in which a component security comprises more than 30 percent of the index's weighting; (iii) in which the 5 highest weighted component securities in the aggregate comprise more than 60 percent of the index's weighting; or (iv) in which 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 million (or in the case of an index with 15 or more component securities, \$30 million), 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." See Exchange Act Section 3(a)(55)(B) and CEA Section 1a(35)(A). The Securities Act, the 1940 Act and the Advisers Act also define a narrow-based security index by cross reference to the definition of a security future in the Exchange Act. See *supra* note 5.

⁷ In this regard, the CFMA provided relief to securities exchanges, boards of trade, and market intermediaries to lessen some of the burdens associated with being subject to a dual jurisdictional structure. For example, in order to permit a board of trade that has been designated as a contract market by the CFTC under Section 5 of the CEA (a designated contract market, or "Futures Exchange") to serve as a marketplace for security futures products without having to fully register as a securities exchange with the SEC, Exchange Act Section (6)(g) (as added by the CFMA) permits Futures Exchanges to register as securities exchanges with the SEC through a notice process, subject to certain conditions. Similarly, Section 5f of the CEA (as added by the CFMA) permits securities exchanges to be deemed designated contract markets for purposes of trading security futures. In addition, persons who intermediate transactions in security futures products are subject to the broker-dealer registration requirements of Exchange Act Section 15(b) and to the futures commission merchant (FCM) registration requirements of CEA Section 4d(a). As with exchanges and boards of trade, a firm that is fully registered as an FCM with the CFTC, or as a broker-dealer with the SEC, may register with the other agency through a notice process. See *e.g.*, Section 4f(a)(2) of the CEA and Section 15(b)(11) of the Exchange Act, and the rules and regulations thereunder.

⁸ See Exchange Act Section 6(h)(1).

⁹ See Exchange Act Section 6(h)(2).

¹⁰ See Section 1a(19)(iii) of the CEA.

¹¹ See Section 1a(19)(iv) of the CEA.

¹² Exchange Act Release No. 61136 (Dec. 10, 2009), 74 Fed. Reg. 66711, 66713 (Dec. 16, 2009) (2009 SEC Order) (citing to Exchange Act Release No. 55871 (June 6, 2007), 72 Fed. Reg. 32376 (June 12, 2007)).

¹³ See *supra* note 12.

¹⁴ See letter from Julian Hammer, Assistant General Counsel, CFTC to Elizabeth King, Associate Director and James L. Eastman, Chief Counsel and Associate Director, Division of Trading and Markets, SEC dated May 4, 2009, available at sec.gov/comments/sr-cboe-2009-022/cboe2009022-1.pdf.

¹⁵ In this regard, absent statements from the SEC or its staff that caution against market participants entering into these contracts other than on a registered or notice-registered securities exchange, it is unclear whether the SEC would seek to institute enforcement proceedings against end-users of the Index Contract.

¹⁶ The Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010).

¹⁷ Exchange Act Release No. 67453 (July 18, 2012), 77 Fed. Reg. 48208 (Aug. 13, 2012) (2012 Release). As reflected in the SEC Letter, the CFTC and the SEC did state in the 2012 Release that “a security index in most cases is designed to reflect the performance of a market or sector by reference to representative securities or interests in securities.” *Id.* 77 Fed. Reg. at 48285.



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