

SUBJECT: Letter from the Division of Market Regulation to the CFTC commenting on the application of the Kansas City Board of Trade ("KCBT") to trade a futures contract based on the Value Line Composite Average.

REQUEST: That the Commission authorize the Division to send the attached letter.

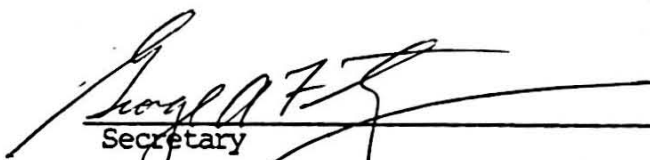
- X) SERIAM CONSIDERATION Pursuant to the provisions of 17 CFR 200.41(a), the Chairman or the undersigned member of the Securities and Exchange Commission, acting as Duty Officer of the Commission, is of the opinion that joint deliberation among the members of the Commission upon the above matter is unnecessary in light of the nature of the matter, impracticable, or contrary to the requirements of agency business but is of the view that such matter should be the subject of a vote of the Commission.
-) DUTY OFFICER CONSIDERATION - Pursuant to the provisions of 17 CFR 200.42(b)
-) EMERGENCY CALENDAR CONSIDERATION - Week of _____

REASON MATTER CANNOT AWAIT COMMISSION ACTION UNDER NORMAL SCHEDULE:

The CFTC intends to act on the KCBT proposal on February 16, 1982.

Vote by Monday 2/8/82 requested.
gf


Requesting Division Director


Secretary


Duty Officer Commissioner
Date: February 5, 1982

	<u>Seriatim Commission Action</u>	<u>Duty Officer Action</u>	<u>Deferred for Regular Calendar</u>
	<u>Apprvd</u> <u>Date</u>	<u>Affirmed - Date</u>	
Chairman Shad <i>pk</i>	<u>PAH</u> <u>2/5/82</u>	_____	_____
Commissioner Loomis	<u>PLB</u> <u>2/8/82</u>	_____	_____
Commissioner Evans	<u>PLB</u> <u>2/5/82</u>	_____	_____
Commissioner Thomas	<u>PLB</u> <u>2/5/82</u>	_____	_____
Commissioner Longstreth	<u>PLB</u> <u>2/5/82</u>	_____	_____
		Date of Action: <u>2-9-82</u>	

M E M O R A N D U M

February 5, 1982

TO: The Commission

FROM: Division of Market Regulation

SUBJECT: Comment letter to the CFTC on the application of the Kansas City Board of Trade ("KCBT") for contract market designation in a futures contract based on the Value Line Composite Average. *RK*
RTC

RECOMMENDATION: That the Commission authorize the Division to send the attached letter to the CFTC.

ACTION REQUESTED BY: Seriatim Consideration

NOVEL, IMPORTANT OR COMPLEX ISSUES: This is the first instance of CFTC consultation with the Commission relating to its consideration of a proposal to trade a futures contract on a securities index or group pursuant to the recent SEC/CFTC jurisdictional accord.

VIEWS OF OTHER OFFICES AND DIVISIONS CONSULTED: Office of the General Counsel (J. Shinkle concurs)

PERSONS TO CONTACT: Richard T. Chase (x22405)
D. Michael Lefever (x23117)

Attached for Commission review is a draft letter to the CFTC commenting on the KCBT's application for designation as a contract market for trading a futures contract based on the Value Line Composite Average ("VLA"). 1/ The Commission previously submitted a comment letter to the CFTC concerning this proposal that set forth our concerns regarding the potential impact of

1/ The Value Line Composite Index is calculated on the basis of the market prices of approximately 1,700 exchange-traded and over-the-counter stocks.

a number of regulatory disparities between trading in the proposed VLA futures contract and trading in Commission-authorized securities options. In the letter the Commission also questioned the existence of an "economic purpose" for the proposed futures contract as is required by Section 5(g) of the Commodity Exchange Act ("CEA") and whether settlement of the proposed contract in cash prevented the CFTC from approving the proposal. 2/

Since the transmittal of that letter, however, the Commission has reached an accord with the CFTC concerning certain jurisdictional issues. Under the accord, the CFTC would be permitted to approve an application of a board of trade for designation as a contract market for trading a futures contract on a group or index of securities provided (i) that settlement of the futures contract is limited to delivery of cash or exempted securities (other than municipal securities); (ii) that trading in the futures contract is not readily susceptible to manipulation nor can be used for the purpose of effecting a manipulation of the price of any underlying security, an option on such security, or an option on a group or index including such securities; and (iii) that the index or group is a widely published measure of and reflects the market for all publicly-traded equity or debt securities or a substantial segment thereof. Under the terms of the accord, the CFTC must consult with the Commission regarding the eligibility of a particular securities index or group for futures trading. On the basis of this provision of the accord, we have received a letter from the CFTC offering the Commission the opportunity to submit any additional comments.

In general, because of the number and diversity of the stocks comprising the VLA, we believe that it reflects a substantial segment of the market for all publicly-traded equity securities. For the same reasons, we do not believe that the proposed futures contract could be manipulated through trading activity in the markets for the underlying securities, nor could trading activity in the futures contract adversely affect the markets for the

2/ Letter to James M. Stone, Chairman, CFTC, from Irving M. Pollack, Commissioner, SEC (February 19, 1980). The Commission also has commented on proposals by the KCBT to trade a futures on the Dow Jones Industrial Average (Letter to William T. Bagley, Chairman, CFTC, from Irving M. Pollack, Commissioner, SEC (August 21, 1978)), and by the Chicago Mercantile Exchange to trade a futures contract on the Standard and Poor's 500 Stock Average (Letter to John L. Manley, Director, Division of Trading and Markets, CFTC, from Ralph C. Ferrara, General Counsel, SEC (June 4, 1981)). Both letters generally discussed the same issues as the KCBT VLA letter.

underlying stocks or options on such underlying stocks. In the draft letter these conclusions with respect to the VLA are discussed in the context of the qualification criteria under the SEC/CFTC accord, thereby establishing a substantive basis for evaluating other securities index or group futures proposals which may present a closer question. 3/

As indicated, the Commission's previous letters raised concerns regarding the regulatory disparities between Commission-regulated options on securities and CFTC-regulated futures on securities indexes, and the absence of an economic purpose and proposed cash settlement of index futures contracts. To the extent that these matters relate to an interpretation of the commodities laws, the draft letter indicates that they no longer reflect current Commission concerns. The draft letter, however, states that regulatory disparities in the trading of index futures and securities options continue to raise concerns that merit careful attention by both the CFTC and the Commission.

3/ The accord also requires that the CFTC find that a proposed futures contract on an index or group of securities is not susceptible to manipulation by, or be used to manipulate, options on that index or group. As a general matter, the number and diversity of the stocks comprising an index or group is not relevant in assessing the impact of trading in a proposed futures contract on an options contract on the same index or group that is regulated by the Commission. Prevention of such manipulation primarily would be a function of the quality of inter-market surveillance through information sharing between the agencies and their respective regulated exchanges. Since there currently is not a proposal by a national securities exchange to trade an options contract on the VLA this concern is not addressed in the letter.



SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

DIVISION OF
MARKET REGULATION

February 9, 1982

Mr. James A. Culver
Director, Division of Economics and Education
Commodity Futures Trading Commission
2033 K Street, N.W.
Washington, D.C. 20581

Re: Application of the Kansas City Board of Trade for Designation
as a Contract Market for Trading a Futures Contract Based
Upon the Value Line Composite Average

Dear Mr. Culver:

Thank you for your letter of December 31, 1981, in which you offer the Commission, in light of the recent CFTC/SEC accord on jurisdictional issues, an opportunity to submit additional comments on the application of the Kansas City Board of Trade ("KCBT") for contract market designation in a futures contract based upon the Value Line Composite Average ("VLA"). 1/

Under the terms of the CFTC/SEC accord the CFTC would be permitted to designate a contract market for futures trading on an index or group of securities provided (i) that settlement of the futures contract is limited to the delivery of cash or exempted securities (other than municipal securities); (ii) that trading in the futures contract is not readily susceptible to manipulation nor can be used for the purpose of effecting a manipulation of the price of any underlying security, an option on such security, or an option on a group or index including such securities; and (iii) that the index or group is a widely published measure of and reflects the market for all publicly-traded equity or debt securities or a substantial segment thereof. Under the terms of the accord, the CFTC must consult with the Commission regarding the eligibility of a particular securities index or group for futures trading.

The proposed KCBT VLA futures contract appears to meet the terms of the accord. It is our understanding that the VLA is an index calculated on the basis of the market prices of approximately 1,700 exchange-listed and over-the-counter stocks. Based on the number of stocks whose market prices are included in the computation of the VLA and the diversity of issuers represented, the VLA appears to reflect a substantial segment of the publicly-traded

1/ The Commission previously commented on the KCBT's VLA proposal in a letter to James M. Stone, Chairman, CFTC, from Irving M. Pollack, Commissioner, SEC, dated February 19, 1980.

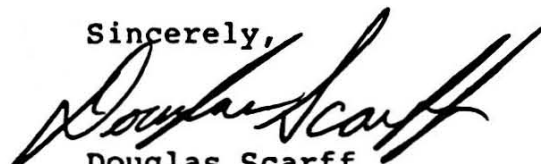
Mr. James A. Culver
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equity securities market. Moreover, it does not appear that the KCBT VLA futures contract is readily susceptible to manipulation or that it could be used to manipulate the price of any underlying stock or options on such underlying stocks. While futures trading on an index in which one security or a small number of securities are dominant or exercise price leadership over the other securities comprising the index might raise manipulative concerns, the Commission does not believe that a futures contract on an index that is sufficiently broad-based, such as the proposed KCBT VLA futures contract, is readily susceptible to manipulation through trading in the underlying market for the individual securities. Conversely, it does not appear that the existence of a futures contract on the VLA potentially could be disruptive of the underlying securities markets.

The Commission's previous comment letter raised a number of concerns regarding the KCBT's VLA proposal. In light of the CFTC/SEC jurisdictional accord, certain of those comments, such as those relating to cash settlement of the contract, no longer reflect current Commission concerns. However, regulatory disparities in the trading of index futures and securities options continue to raise concerns that merit careful attention by both the CFTC and this Commission.

Thank you for this additional opportunity to comment. Please contact me if the Commission can be of any further assistance to the CFTC in its consideration of this contract.

Sincerely,



Douglas Scarff
Director