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MAY 18 1982

OFFICE OF GENERAL COUNSEL

OFFICE OF THE CHAIRMAN

05/16/82

PLEASE TAKE THE ACTION INDICATED WITH REGARD TO THE ATTACHED CORRESPONDENCE.

AFFILIATION:

LETTER FROM: DINGELL JOHN CONG

DATE OF CORRES: 05/13/82 INTERNAL RESP DUE: 05/21/82 CONTROL NO.: 009662

SUBJECT: LT FRM MR TO CFTC/CMTS ON CBT STCK, MRKT INDEX

ASSIGNED TO: GREENE

ACTION REQUIRED: REPLY FOR SIGNATURE OF CHAIRMAN
STAFF REPORT.

REMARKS:

SPECIAL INSTRUCTIONS:

SEE CHAIRMAN'S CORRESPONDENCE MANUAL
FOR DETAILS REGARDING PROPER FORMAT
AND ASSEMBLY OF RESPONSE

TO: THE CHAIRMAN

DATE:

THE FOLLOWING ACTION
WAS TAKEN WITH RESPECT
TO THIS CORRESPONDENCE:

JOHN D. DINGELL, MICH., CHAIRMAN

JAMES H. SCHEUER, N.Y.
 RICHARD L. OTTINGER, N.Y.
 HENRY A. WAXMAN, CALIF.
 TIMOTHY E. WIRTH, COLO.
 PHILIP R. SHARP, IND.
 JAMES J. FLORIO, N.J.
 ANTHONY TOSY MOFFETT, CONN.
 JIM SANTINI, NEV.
 EDWARD J. MARKEY, MASS.
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 DOUG WALGREN, PA.
 ALBERT GORE, JR., TENN.
 BARBARA A. MIKULSKI, MD.
 RONALD M. MOTT, OHIO
 PHIL GRAMM, TEX.
 AL SWIFT, WASH.
 MICKEY LELAND, TEX.
 RICHARD C. SHELBY, ALA.
 CARLIS COLLINS, ILL.
 MIKE SYNAR, OKLA.
 W. J. "BILLY" TAUZIN, LA.
 RON WYDEN, OREG.
 RALPH M. HALL, TEX.

JAMES T. BROTHILL, N.C.
 CLARENCE J. BROWN, OHIO
 JAMES M. COLLINS, TEX.
 NORMAN F. LENT, N.Y.
 EDWARD R. MADIGAN, ILL.
 CARLOS J. MOORHEAD, CALIF.
 MATTHEW J. RINALDO, N.J.
 MARC L. MARKS, PA.
 TOM CORCORAN, ILL.
 GARY A. LEE, N.Y.
 WILLIAM E. DANNEMEYER, CALIF.
 BOB WHITTAKER, KANS.
 THOMAS J. TAUBE, IOWA
 DON RITTER, PA.
 HAROLD ROGERS, KY.
 CLEVE BENEDICT, W. VA.
 DANIEL R. COATS, IND.
 THOMAS J. BLILEY, JR., VA.

**U.S. House of Representatives
 Committee on Energy and Commerce**

Room 2125, Rayburn House Office Building

Washington, D.C. 20515

May 13, 1982

FRANK M. POTTER, JR.
 CHIEF COUNSEL AND STAFF DIRECTOR

Honorable John S.R. Shad
 Chairman
 Securities and Exchange Commission
 500 North Capitol Street
 Washington, D. C. 20549

CHAIRMAN'S OFFICE

RECEIVED

MAY 18 1982

SEC. & EXCH. COMM.

Dear Mr. Chairman:

I have recently received a copy of a letter from Douglas Scarff, Director, Division of Market Regulation, Securities and Exchange Commission, to James A. Culver, Director of Economics and Education, Commodity Futures Trading Commission. The letter bears a handwritten notation "sent 5/10/82" and purports to be comments on the application of the Chicago Board of Trade (CBT) for designation as a contract market for trading a futures contract based on the CBT stock market index. Regretfully, I must advise you that I find that letter raises serious questions as to the discharge of your responsibilities under the federal securities laws and pursuant to the jurisdictional accord between your agency and the CFTC.

My concerns are heightened by the alleged irregularities and illegalities attendant to the development, consideration and approval of this contract application. A copy of the complaint in Dow Jones & Company, Inc. v. CFTC et al is enclosed with my letter.

Within fifteen days following the close of the public comment period, the SEC is required to have commented on the application of a board of trade for designation as a contract market for futures or options on futures involving a group or index of securities. The SEC may object to such designation on the ground that any minimum requirement is not met. On page 2, the Scarff letter states that "the contract appears to raise some concern with regard to the second and third factors." The Joint Statement released by you and the CFTC on December 7 states that

Honorable John S.R. Shad
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any securities index futures contract that does not meet the three tests will not be permitted to trade. Accordingly, it is not clear to me why this does not dictate opposition to the contract. It is equally unclear why the remainder of the letter see-saws between raising objections to the contract and trying to explain those objections away. This is in marked contrast to the very strong, well-reasoned letters submitted by the Chicago Board Options Exchange and Dow Jones, neither of which have been entrusted with responsibilities for the Nation's trading markets.

In addition, I request your response to the following by May 21, 1982:

*Deadline
Extended 5
days -*

1. The comment period for the CBT application expired on Friday, May 7. CFTC consideration was scheduled and then rescheduled for May 11 and May 13. The accord calls for a fifteen-day period between the close of the public comment period and CFTC consideration to afford the SEC an opportunity to comment on whether the contract meets the three minimum requirements set forth in the accord. Why was this time period not observed?

2. a. You note that the CBT proposal raises the same regulatory concerns raised by the Commission in its previous comment letters to the CFTC. However, you take the view that, while these important regulatory problems continue to merit the "careful attention" of both agencies, there is no need to use the leverage of the review process to obtain redress of these issues. The willingness of the CFTC and the self-regulatory organizations to take on more effective rules and a broader commitment of resources is still to be tested. It is hard to see how "careful attention" will prevent manipulation and other abuses; the horse may already have been stolen as a result of your failure to object to CFTC approval of this contract. Please explain how "careful attention" will result in redress of your regulatory concerns. Please explain what specific steps you propose to take if your "careful attention" should reveal abuses.

b. A review of your previous comment letters reveals that one of the objections raised was that trading of index futures contracts would negatively affect capital formation. The SEC also expressed concern that trading in such a futures contract would have an adverse impact upon the Nation's equity markets as well as the SEC's ability to ensure manipulation-free securities trading. Please provide me with copies of any studies and other evidence which would justify your apparent reversal and abandonment of this traditional concern.

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3. a. On page 4, you note that "the proposed CBT futures contract is based on an index that raises questions in connection with several of the factors utilized by the Commission to evaluate the potential for manipulation." Why did you not object to the CBT contract application for that reason?

b. Is there a surveillance information exchange agreement (see fn. 6) in connection with this contract? If so, please provide a copy. If not, on what basis did you form an opinion without the existence of what you yourself consider "a significant factor... in reducing the potential for such manipulation"?

4. a. The third standard or criterion requires indices to be "broad-based" and reflective of the market as a whole, or of a substantial segment thereof. The four contracts considered and approved by the CFTC thus far involved indices consisting of at least 500 stocks that were "broad-based" and generally reflective of publicly-traded equity securities. On its face, an index comprised of only 30 stocks would clearly seem not to be "broad-based."

On page 5, you state:

Although the Commission believes that generally an index comprised of only 30 stocks would not be appropriate for futures trading because of the manipulative concerns such a futures contract would pose, we do not interpose any objection to the proposed contract under the third criterion of the accord in view of the heavy capitalization, broad diversification and deep and liquid markets of the securities comprising the DJIA.

I fail to see how this justifies your failure to object to the contract under the "broad-based" requirement, the third criterion of the accord. Please elaborate and explain how these points militate against failure to satisfy that requirement. Also explain why they nullify the contract's failure to satisfy the criterion dealing with manipulation. Finally, the CBT application goes to great lengths to distinguish their clone from the DJIA and yet your analysis assumes that you are dealing with the DJIA and places reliance on characteristics of the DJIA. Please explain your reasons for doing so.

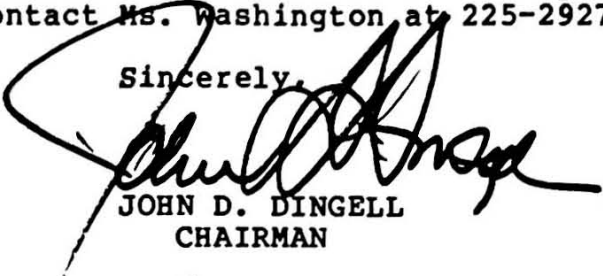
b. If the SEC will not object to CFTC approval of such "narrowly-based" indices, what is the point of the jurisdictional

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accord on this issue? Please specify what factors, if any, will cause the SEC to object to approval of a contract. Please provide copies of any guidelines you have developed.

I stress that the Commission comply with the above deadline in a timely fashion so that we can fully and fairly evaluate the operation of the jurisdictional accord, particularly your ability to carry out your responsibilities under that accord. If you have any questions, please contact Ms. Washington at 225-2927.

Sincerely,



JOHN D. DINGELL
CHAIRMAN

Enclosure

cc: Commissioners
Phillip A. Loomis, Jr.
John R. Evans
Barbara S. Thomas
Bevis Longstreth

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

WJS
5/12/82

Re: The Application of the Chicago Board of Trade ("CBT")
for Designation as a Contract Market for Trading a
Futures Contract Based on the CBT Stock Market Index.

Dear Mr. Culver:

The Commission has recently received notification that on May 11, 1982, the CFTC will consider the application of the CBT requesting designation as a contract market for trading a futures contract based on the CBT Stock Index of 30 industrial stocks. Because the CBT Stock Index is identical to the Dow Jones Industrial Average ("DJIA"), our comments concerning the index underlying the futures contract refer to the index as the DJIA for the sake of brevity and clarity.

In view of the recent CFTC/SEC accord, the Commission welcomes the opportunity to submit comments on the proposed futures contract based on the DJIA. Although we are aware that the CBT has proposed a number of futures contracts 1/ which it wishes the CFTC to consider, we understand that the CFTC has deferred reviewing the proposed futures contracts based on smaller indices and stock portfolios and will consider only the proposed futures contract based on the DJIA on May 11, 1982. Accordingly, our comments pertain only to the futures contract under consideration at this time and do not reflect Commission views on the CBT proposal in its entirety.

1/ In addition to the proposed futures contract based on the DJIA under consideration, it is our understanding that the CBT has proposed futures contracts based on: (i) a Transport Index comprised of 20 stocks and identical to the Dow Jones Transportation Average ("DJTA"); (ii) a Gas and Electric Index comprised of 15 stocks and identical to the Dow Jones Utilities Average ("DJUA"); and (iii) ten "Industry Portfolios," entitled Air Transport, Automotive, Banking, Chemical, Drug, Information Processing, Petroleum, Photo-Optic, Retail and Telecommunication.

The terms of the CFTC/SEC accord provide that the CFTC would be permitted to designate a contract market for futures trading on an index or a group of securities if (i) settlement of the futures contract is limited to the delivery of cash or exempted securities (other than municipal securities); (ii) the index or group of securities on which the proposed contract is based is a widely-published measure of the market for a substantial segment of or all publicly-traded equity or debt securities and reflects that market, or is comparable to such measure; and (iii) trading in the futures contract is not readily susceptible to manipulation, nor to causing or being used in the manipulation of the price of any underlying security, an option on such security, or an option on a group or index including such securities. In addition, the CFTC has agreed to consult with the Commission regarding the eligibility of a securities index or group for futures trading.

In viewing the proposed futures contract under the three criteria of the accord, the first requirement is clearly met. The proposed CBT contract provides for cash settlement. However, the contract appears to raise some concern with regard to the second and third factors.

The second factor of the accord requires the underlying index or group to be a widely-published measure of the market for a substantial segment of or all publicly-traded equity securities. The DJIA is composed of significantly fewer stocks than the indices underlying previously proposed futures contracts on which the Commission has commented. 2/ The DJIA

2/ The Kansas City Board of Trade ("KCBT") proposed a futures contract based on the Value Line Composite Average ("VLA"). Comment letter to James A. Culver, Director, Division of Economics and Education, CFTC, from Douglas Scarff, Director, Division of Market Regulation, SEC, dated February 9, 1982 ("KCBT letter"). The Chicago Mercantile Exchange, Inc. ("CME") and the Commodity Exchange, Inc. ("COMEX") proposed similar futures contracts based on the Standard and Poor's 500 Stock Price Index ("S&P 500"). Comments letters to James A. Culver from Douglas Scarff, dated April 19, 1982 ("CME Letter") and April 23, 1982 ("COMEX letter"). The New York Futures Exchange ("NYFE") proposal to trade a futures contract based on the New York Stock Exchange ("NYSE") Composite Index ("NYSECI") was the most recent contract under consideration. Comment letter to James A. Culver from Douglas Scarff, dated May 3, 1982 ("NYFE letter").

consists of 30 stocks in contrast to the 500 to 1,685 stocks comprising the previously considered stock indices. 3/ However, the DJIA, comprised of widely held, heavily capitalized and diversified entities, generally parallels the movements of the larger indices and for the most part appears to reflect the overall equity securities market. 4/

The accord also requires the CFTC to find that a proposed index futures contract is not readily susceptible to manipulation. In this regard, the factors considered in our prior comments concerning the proposals by the CME, COMEX and NYFE also appear relevant here. 5/ In evaluating the manipulative potential of a proposed index futures contract as it relates to the securities that comprise the index, among the factors considered by the Commission have been: (i) the number of securities comprising the index or group; (ii) the capitalization of those securities; (iii) the depth and liquidity of the secondary market for those securities; (iv) the diversification of the group or index; and (v) whether the index or group is weighted. 6/

3/ As noted in our prior letters, the NYSECI, the S&P 500 and the VLA appear to reflect a substantial segment of the market of publicly-traded equity securities.

4/ In considering the proposed futures contract, the Commission's comments under the terms of the accord contemplate a futures contract which is based on an index which mirrors the DJIA. Although the CBT proposal does not expressly provide that any change in the composition of the DJIA would result in a similar change in the CBT stock index, the Commission believes that the failure to make such a change would, in essence, result in the creation of a different futures contract which would be subject to the consideration of the SEC and CFTC under the terms of the accord.

5/ Footnote 2, supra.

6/ In many respects, however, the factors enumerated above may not be helpful in determining, as required by the accord, that a proposed futures contract is not readily susceptible to manipulation by, or cannot be used to manipulate, options on that index. Prevention of such

(Footnote Continued)

✓ Unlike the previous stock index futures contracts considered by the CFTC, 7/ the proposed CBT futures contract is based on an index that raises questions in connection with several of the factors utilized by the Commission to evaluate the potential for manipulation. The DJIA reflects the daily price movements of only 30 stocks. In addition, the index is not weighted, and thus does not reflect the average change in total market value of the securities comprising it. However, in this instance, the index under consideration does not appear to be readily susceptible to manipulation, given the broad diversification of the index and the characteristics of the securities comprising it. The DJIA reflects the prices of 30 heavily capitalized stocks; its total capitalization or market value was \$225 billion as of December 31, 1981. 8/ In addition, the securities are widely

(Footnote Continued)

manipulation to a great extent would be a function of the quality of inter-market surveillance through information sharing between the agencies and their respective regulated markets. As indicated in our previous letters, an agreement to exchange surveillance information between the futures market seeking contract designation and the exchange markets on which either the options on the index or the securities that comprise the index are traded is considered a significant factor by the Commission in reducing the potential for such manipulation. See NYFE letter at p. 3, CME letter at p. 2 and COMEX letter.

7/ Since February, 1982, the CFTC has considered and approved the KCBT futures contract based on the VLA, the CME futures contract based on the S&P 500 and a similar contract proposed by COMEX, and the NYFE futures contract based on the NYSECI.

8/ While this is roughly one-fourth to one-fifth the capitalization of the indices previously considered, we deem it to be sufficient, in light of the diversification of the index and the depth and liquidity of the markets for the securities comprising the index, to assure that the futures contract is not readily susceptible to manipulation.

✓ held and actively traded. 9/ Although the Commission believes that generally an index comprised of only 30 stocks would not be appropriate for futures trading because of the manipulative concerns such a futures contract would pose, we do not interpose any objection to the proposed contract under the third criterion of the accord in view of the heavy capitalization, broad diversification and deep and liquid markets of the securities comprising the DJIA.

Although an option on a similar index or group is not currently traded on a Commission-regulated exchange, nor is one pending at this time, in the event that such a corresponding option is approved by the Commission, the potential for inter-market manipulation could arise. As the Commission has stated previously, 10/ in view of the potential adverse effects on both the futures market and the securities exchanges trading the similar instruments, provision should be made for an exchange of information for the purpose of surveillance. In this connection, it would appear useful for the CFTC to obtain a commitment from the CBT that, if appropriate legislation is enacted and an options exchange begins trading an option on a similar index, the CBT will cooperate with the relevant options market in exchanging information to detect inter-market manipulation of the related investment instruments.

The CBT proposal raises the same regulatory concerns discussed by the Commission in our previous comments regarding the KCBT VLA futures contract, the CME S&P 500 futures contract, the COMEX S&P 500 futures contract, and the NYFE NYSECI futures contract. 11/ In our view, regulatory disparities in the trading of index futures and securities options continue to merit the careful attention of both the CFTC and this Commission.

9/ The total volume for 1981 for the securities comprising the DJIA was 1,263,791,600 shares. Although the securities comprising the DJIA represent only about two percent of the securities traded on the NYSE, they accounted for over ten percent of aggregate NYSE trading volume in 1981.

10/ NYFE letter at p. 3-4.

11/ Footnote 2, supra.

Mr. James A. Culver
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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 the CBT
proposal.

Sincerely,

Douglas Scarff
Director