



SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

The Honorable John D. Dingell
Chairman
Committee on Energy and Commerce
House of Representatives
Washington, DC 20515

Dear Mr. Chairman:

The enclosed staff report is in response to your letter of December 9, 1982 regarding the new options and futures products which have been, and are being, developed by securities exchanges and boards of trade.

If you have additional questions, please contact me or Richard Ketchum, an Associate Director in the Division of Market Regulation at (202) 272-2866.

Sincerely,

John S.R. Shad

Enclosure

MEMORANDUM

February 10, 1983

TO: Chairman Shad

FROM: Division of Market Regulation *AK*

SUBJECT: Response to Congress Dingell Regarding
New Product Proliferation

In a letter dated December 9, 1982 Congressman John D. Dingell inquired about the new options and futures products which have been, and are being, developed by securities exchanges and boards of trade. In his letter, he expressed concern about the ability of the financial services industry to absorb the new products and he questioned whether the various exchanges and boards of trade are adequately regulating and monitoring trading activity in these products. Congressman Dingell asked that the Commission consult with the Commodity Futures Trading Commission ("CFTC") and the securities exchanges that the Commission regulates and provide him with information concerning how the Commission has addressed, and intends to address, reports of investor confusion, broker-dealer abuses and regulatory surveillance shortcomings attending the trading start-up of new products. He also inquired how the Commission intends to treat future requests for approval of new options and futures contracts in light of new product proliferation.

The Division concluded that it would best be able to provide him with useful information regarding new option products under the Commission's jurisdiction through direct input from the securities exchanges that trade or have been approved to trade new options products. Accordingly, following receipt of Congressman Dingell's letter, the staff sent letters to the New York Stock Exchange, Inc. ("NYSE"), the Chicago Board Options Exchange, Incorporated ("CBOE"), the American Stock Exchange, Inc. ("Amex") and the Philadelphia Stock Exchange, Inc. ("Phlx") requesting information that would be helpful in responding to his letter. ^{1/} In addition, the staff of the CFTC has been provided with a copy of Congressman Dingell's letter and the staff is meeting on a frequent basis with the staff of the CFTC to discuss issues of mutual concern. The responses provided below reflect the information received as a result of these communications.

^{1/} See, e.g., letter from Douglas Scarff, Director, Division of Market Regulation, SEC, to Charles Henry, President, CBOE, dated January 6, 1983. See Attachment A.

The Commission Role in Approving New Options Products

Although not specifically required by statute, in examining and approving new options products from the securities exchanges, the Commission has considered carefully the economic utility of the proposed products. ^{2/} In this undertaking, the staff has been greatly assisted by numerous public commentators, persons and organizations from the industries that stand potentially to benefit from the existence of the new options markets, and from other government agencies who have attested to the variety of uses that they believe the new options products could serve. ^{3/} In addition, the exchanges have included in their rule filings, or made separate submissions, discussing the economic uses of the proposed new options.

Before approving each proposal, the Commission has also considered the preparedness of the industry and the public for those products. The staff has worked closely with the exchanges to ensure that trading of the new option products has commenced only after the exchanges and their member firms were ready operationally to handle each new product and only after member firms and investors were thoroughly educated about the products. Indeed, Commission approval of these products has been conditioned on the satisfaction of requirements designed to ensure the responsible and orderly start-up of trading as well as securities industry and investor preparedness for these products. ^{4/} The staff, after enactment of the Securities Acts portion of the

^{2/} See, e.g., Securities Exchange Act Release No. 17577 (February 26, 1981), 46 FR 15242 (March 4, 1981).

^{3/} The Commission received comments from the Federal Reserve Board ("FRB"), Federal Reserve Bank of New York ("FRB-NY"), Treasury Department, Government National Mortgage Association and CFTC supporting the concept of a standardized, listed market for GNMA options. The FRB, FRB-NY and Treasury Department submitted similar comments concerning the Treasury options proposals. Overall, the Commission has received over 100 comment letters supporting the various new options product proposals. The only adverse comments have raised jurisdictional concerns that have been resolved by enactment of the Accord legislation.

^{4/} For example, in the Commission's foreign currency options approval order, the start-up of trading was conditioned on Commission approval of OCC rules concerning the issuance, clearance and settlement of foreign currency options, Commission staff review of a foreign currency options

Accord 5/ in early October, requested the Amex, CBOE, and Options Clearing Corporation ("OCC") to indicate what plans, programs and other actions they had taken to ensure the fair and orderly commencement of trading in debt options. In addition, the Division staff demanded at that time, and received, assurances from the Amex and CBOE that both they, and their member firms, were operationally ready to handle these products before trading commenced. 6/

Exchange Preparation for Trading

As described more fully in the attached letters from the securities exchanges, 7/ prior to the start-up of trading in debt and foreign currency options, the exchanges conducted seminars and training sessions for account executives, floor traders, back office personnel and clearing firms. Persons selling, or supervising the sale of, debt or foreign currency options have been required to pass qualifying exams, and several thousand have done so. Each of the exchanges also developed a variety of educational materials for use by member firms and

(Footnote Continued)

disclosure document, submission of Phlx and Division review of foreign currency options surveillance materials, and Division review and approval of Phlx technical rules concerning margining and settlement of foreign currency options and delivery to public customers of foreign currency options disclosure materials. See Securities Exchange Act Release No. 19133 (October 14, 1982). Similar conditions were imposed by the Commission in connection with the approval of other new options product proposals.

5/ Pub. L. No. 97-303 (October 13, 1982).

6/ A copy of the preparedness letter from the Amex is annexed as Exhibit A to that exchange's response to Douglas Scarff's January 6, 1983 letter. See Attachment D.

7/ See letter dated January 25, 1983 to Douglas Scarff, Director, Division of Market Regulation, SEC, from Charles J. Henry, President, CBOE ("CBOE letter"); letter dated January 20, 1983 to Douglas Scarff, from Nicholas A. Giordano, President, Phlx ("Phlx letter"); letter dated February 2, 1983 to Douglas Scarff from Robert J. Birnbaum, President, Amex ("Amex letter"). See Attachments B, C, and D, respectively.

individuals to understand the mechanics of the new instruments. Furthermore, in conformity with a revised disclosure system for options recently adopted by the Commission, the exchanges have established procedures to ensure that adequate disclosure concerning the mechanics, risks and uses of these new products is made to investors before their accounts are approved for trading the product. 8/ The exchanges, with the assistance of OCC, have prepared disclosure documents with respect to debt options and foreign currency options. These documents were filed with the Commission and reviewed by the Division staff prior to use. 9/ In addition, separate account approval must be obtained before an investor can trade debt options or foreign currency options, even if the investor is already qualified to trade stock options.

The Division believes that the securities exchanges have moved cautiously and responsibly in proposing and implementing new options product programs. Trading commenced slowly in Treasury bond, note and bill options approximately one week after Commission approval in October 1982. 10/ Trading in options on foreign currency began approximately two months after the Commission's October 1982 approval order, with trading commencing in just one of the five foreign currencies approved

8/ On September 16, 1982, the Commission adopted a new simplified disclosure system under which the basic prospectus was replaced by a core options disclosure document designed to explain the mechanics, risks and uses of standardized options trading. See Securities Exchange Act Release No. 19055. In addition to the basic disclosure document, supplemental documents have been prepared for debt options, foreign currency options and stock index options.

9/ The Division currently is in the process of reviewing a disclosure document covering stock index options.

10/ The industry, of course, had more than one week to prepare for the advent of trading in Treasury options. Options on Treasury securities were initially proposed by the securities exchanges in 1977 and again in early 1980. Commission approval of Amex and CBOE Treasury options proposals on December 23, 1981 resulted in a lawsuit from two commodities exchanges. As you are aware, this and related litigation was in part responsible for the discussions that led to the SEC/CFTC Accord. It was generally understood by the industry that trading in Treasury options would commence shortly after the enactment of legislation implementing the Accord.

as underlying instruments. 11/ Trading in the remaining four foreign currency options has been introduced gradually in staggered intervals since then. Trading volume in all of these products has been relatively low, averaging between 200 and 600 contracts a day.

The Commission authorized the CBOE to trade options on Government National Mortgage Association pass-through certificates ("GNMAs") in October, and the Amex to trade options on certificates of deposit ("CDs") and the Amex, CBOE and NYSE to trade options on stock indices in November 1982. The exchanges, however, have not yet begun trading these options products. Rather, as the exchanges indicate in their responses to Mr. Scarff's January 6 letters, they have been monitoring the development of the currently traded options products before introducing these products, both to assure that the markets for the existing options are firmly established before introducing new trading instruments and to assure that their member firms are prepared for the introduction of those new instruments.

As a result of this careful phase-in, trading in options on Treasury securities and foreign currency has proceeded smoothly without any indication of confusion on the exchange floors. Moreover, Division monitoring has not uncovered any serious firm back office or clearing problems in the new options products.

As with the planning for trading in Treasury and foreign currency options, various programs and actions have been, and are being, undertaken by the exchanges and member firms to ensure the fair and orderly commencement of trading in options on GNMAs, CDs and various stock indices. 12/ Again, the Commission has conditioned the commencement of trading in these products on the satisfaction of requirements designed to ensure the responsible and orderly start-up of trading as well as regulatory and investor preparedness for these products. As the attached letters reflect, no firm dates have yet been set for the start-up

11/ In this regard, the Commission received assurances from Phlx prior to approving the basic foreign currency options rules package that Phlx did not intend to commence trading until two months after Commission action in order to provide Phlx floor members and the industry an opportunity to prepare for an orderly start-up of trading.

12/ See Amex and CBOE letters. See also letter dated January 20, 1983 to Douglas Scarff from John J. Phelan, Jr., President, NYSE. See Attachment E.

of trading in GNMA and CD options, although the exchanges have indicated they would like to start trading options on various stock indices in early spring 1983.

Future Requests

At this time, the Division is not aware of plans by any securities exchanges to request approval of any new options products in the immediate future other than options on specific sector indices. In examining any future new options product proposals, the Division intends to continue to examine closely the economic need for the product and the steps taken by the exchanges to provide for industry preparedness to trade the product, particularly in light of the concerns that have been expressed regarding proliferation.

New Futures and Options on Futures Products

The commodity exchanges have been authorized to trade, or have applications for designation as contract markets for, numerous futures on exempt securities, broad stock indices, sector indices and groups of stock, and in some instances, on options on those futures. As Congressman Dingell is aware, the SEC/CFTC Accord established a procedure for SEC review of board of trade proposals to trade future contracts on stock groups or stock indices. For proposals filed before December 9, 1982, the SEC has a consultative role. For proposals filed after that date, the CFTC is required to transmit the proposals to the SEC, which may by order determine that a proposed contract fails to meet the requirements of Section 2 of the Commodity Exchange Act. The Division takes its responsibilities regarding stock index futures contracts seriously and the staff carefully examines, and consults extensively with CFTC staff regarding, each proposed index futures contract. In this connection, the Commission has sent a number of comment letters to the CFTC on various stock index futures proposals and options on stock index future proposals, and intends to continue to perform this role under the Accord. ^{13/} To date, the Division believes the Commission's consulting relationship with the CFTC has worked extremely well and, as a result, the CFTC has considered

^{13/} The Commission has submitted the following comment letters to the CFTC concerning proposed stock index futures contracts. See comment letters to James A. Culver, Director, Division of Economics and Education, CFTC, from Douglas Scarff,

(Footnote Continued)

and approved only proposed index contracts which the Commission has determined clearly meet the statutory standards.

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Director, Division of Market Regulation, concerning: (i) the Kansas City Board of Trade ("KCBT") proposal to trade a futures contract based on the Value Line Composite Average ("VLA"), dated February 9, 1982 (the "KCBT letter"); (ii) the Chicago Mercantile Exchange, Inc. ("CME") proposal to trade a futures contract based on Standard and Poor's 500 Stock Index ("S&P 500"), dated April 18, 1982 (the "CME letter"); (iii) the Commodity Exchange, Inc. ("COMEX") proposal to trade a futures contract based on S&P's 500, dated April 23, 1982 (the "COMEX letter"); (iv) the New York Futures Exchange ("NYFE") proposal to trade a futures contract based on the New York Stock Exchange ("NYSE") Composite Index dated May 3, 1982 (the "NYFE letter"); (v) the Chicago Board of Trade, Inc. ("CBT") proposal to trade a futures contract based on the Dow Jones Industrial Average ("DJIA"), dated May 10, 1982 (the "CBT letter"); (vi) the NYFE proposal to trade futures contracts based on the NYSE Industrial, Financial, Utility and Transportation Indices, dated September 15, 1982 (the "NYFE Sector Index letter"); and (vii) the NYFE proposal to trade a larger futures contract on the NYSE Composite Index, dated November 17, 1982 (the "NYFE Large Composite Index letter").

In addition, the Commission has, based on issues previously considered, commented on the applications of the CME, NYFE and KCBT to trade, respectively, options on futures contracts based on S&P's 500, the NYSE Composite Index and the VLA. See comment letters to James A. Culver, Director, Division of Economics and Education, CFTC, from Douglas Scarff, Director, Division of Market Regulation, concerning: (i) the NYFE and CME options on futures applications, dated December 16, 1982; and (ii) the KCBT option on futures application, dated January 12, 1983.