UNITED STATES OF AMERICA
COMMODITY FUTURES TRADING COMMISSION
2033 K Street, N.W.
Washington, D.C. 20581

June 1, 1988

Jonathan G. Katz
Secretary
Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549

Dear Mr. Katz:

The Commodity Futures Trading Commission is writing in response to your open invitation to comment on proposed rule changes of the American Stock Exchange, Inc. (Exchange) to trade Equity Index Participations (EIPs) on two stock market indices, published at 53 F.R. 16805, May 11, 1988.

Under the proposals the Exchange defines an EIP as a "security based on the spot value of an index of stocks, of indeterminate duration." Rule 900F(b)(1). The Exchange's statement of purpose recites that Equity Index Participations would permit holders to own a security designed to reflect the principal characteristics of ownership of the complement of stocks comprising the Major Market Index ("MMI") and Institutional Index but that does not require the actual purchase or sale of shares of common stock of the issuers included in those indices. Major Market Index Participation ("MMIP") and Institutional Index Participation ("IIP") holders would participate in any appreciation or decline in the MMI or Institutional Index. In the event of a cash-out, settlement would be effected by cash payment to the holder from a person holding a short position, with no delivery of underlying stocks. 53 F.R. 16807. This cash-out privilege is available on the "third Friday" of March, June, September, and December while the contract itself is undated.

Holders of EIPs are entitled to "quarterly payments equivalent to the amount of dividends declared during such quarter by issuers of underlying index stocks." 53 F.R. 16807. The contract size of the Major Market and Institutional Index will represent one-tenth, the index multiplier, times the MMI or Institutional Index value, respectively. The standard unit of trading for both EIP indices is proposed to be 100 EIPs. EIPs will be traded on the Exchange. The EIP instrument will not constitute the purchase or sale of any of the component stocks, nor will it confer voting rights nor rights to receive actual dividends connected with the ownership of stock.

As with the Cash Index Participations proposed by the Philadelphia Stock Exchange, the Commission is of the view that the SEC lacks jurisdiction to authorize trading in the EIPs through approval of the Exchange's proposed rule changes because EIPs do not constitute a "security" as defined in Section 3(a)(10) of the Securities Exchange Act of 1934. A stock index, such as the market basket on which a EIP would be based, is not itself defined as a security under Section 3(a)(10). Instead, under amendments to the securities laws enacted in 1982, in order to constitute a security, an instrument must be an "option" on any security... or group or index of securities (including any interest therein or based on the value thereof)..." Congress also made clear in 1982, however, that not all derivative instruments involving stock indices were included within the amended definition in Section 3(a)(10). Through companion amendments to Section 2(a)(1) of the Commodity Exchange Act, Congress confirmed that this Commission continues to have "exclusive jurisdiction" over trading on futures contracts (and options on futures contracts) "on a group or index of securities (or any interest therein or based on the value thereof)."

The 1982 amendments to the securities laws and to the Commodity Exchange Act codified the Johnson-Shad Accord of 1981, which resolved certain jurisdictional questions between the SEC and the CFTC. The Accord and the implementing legislation specified that, as far as stock indices were concerned, the SEC would have jurisdiction over options directly on stock indices and the CFTC would continue to exercise jurisdiction over futures contracts on stock indices and options on such contracts. See, e.g., H. Rep. No. 97-565, Part 1, 97th Cong. 2d Sess. at 38-39 (1982).

The EIP contracts are not option contracts since they obligate both parties to perform at the price agreed to at initiation of the contracts, thus fully exposing both parties to potential gains or losses equal to the change of the underlying stock index. With a stock index option contract, the option's premium establishes a maximum loss for the purchaser and gain for the grantor resulting from changes in the underlying stock index. Thus, a stock index option is a limited-risk instrument which does not expose its purchaser to the full loss from adverse price changes in the underlying stock index nor permit the grantor to benefit from the full amount of the favorable price change. In addition, there is no apparent option premium paid by the long side of a EIP contract.

As described above, trading in the EIPs, as we understand the Exchange's proposals, would not constitute the trading of an option on an index, but rather the trading of a futures contract "based on the value" of an index. EIPs are agreements for the purchase or sale of a stock index in the future at a price established at the initiation of the contract. EIPs are of "indeterminate" duration so they are not spot contracts. Both parties to an EIP are obligated to fulfill their obligations based on the agreed upon price. Finally, the structure of the proposed instrument, as well as its purpose as stated by the Exchange, clearly indicates that its primary use would be for speculation or hedging.

EIPs have other features that have traditionally facilitated the trading of futures on exchanges. These features include: initial and maintenance margin requirements (Rule 462(d)8) and 53 F.R. 16807; a clearinghouse (the Options Clearing Corporation); and standardized terms and conditions.

Accordingly, the trading of such an instrument may lawfully occur only on a contract market designated by this Commission. 7 USC Section 6(a). Any such designation, of course, would depend upon whether the Exchange's proposal met the relevant criteria under the Commodity Exchange Act, including the specific standards for futures on stock indices and subject to the SEC's role in the designation process.

The Commission has no objection in principle to the trading of a cash market instrument that involves a market basket of securities. We would be pleased to work with the Securities and Exchange Commission on the appropriate means to implement such an objective that would not be contrary to the Commodity Exchange Act.

Very truly yours,

Jean A. Webb

Jean A. Webb
Secretary of the Commission