

UNITED STATES OF AMERICA
COMMODITY FUTURES TRADING COMMISSION

2033 K Street, N.W.
Washington, D.C. 20581



July 8, 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 Chicago Board Options Exchange, Inc. (Exchange) to trade Value of Index Participations (VIPs) on up to four stock market indices, published at 53 F.R. 22754, June 17, 1988.

Under the proposals the Exchange defines a VIP as a "security based on the spot value of an index of stocks multiplied by the VIP multiplier, of indeterminate duration and paying its purchasers a proportionate share of dividends declared on the component stocks of the index." Rule 25.1. The Exchange's statement of purpose recites that "Value of Index Participations are designed to allow investors to participate fully in the performance of the portfolio of stocks comprising the index while enjoying the lower transaction costs associated with cash-settled index options. While certain stock ownership benefits are simulated, VIPs do not give to holders either the right to actual dividends declared by the issuer or the right to vote the underlying shares." VIPs may be settled by a quarterly "cash-out." In the event of a cash-out, settlement would be effected by cash payment to the long holder from a person holding a short position, with no delivery of underlying stocks. 53 F.R. 22754. This cash-out privilege is available on the business day prior to the "third Friday" of March, June, September, and December while the contract itself is undated.

Holders of VIPs are entitled to "cash payments equivalent to a proportionate share of any regular cash dividends." 53 F.R. 22756. VIPs will be based on up to four stock indices, the CBOE 50, CBOE 250, S&P 100 and S&P 500. The contract size of VIPs will represent one-tenth of the CBOE 50, CBOE 250, S&P 100 or S&P 500 Index values, respectively. The standard unit of trading for all VIP indices is proposed to be 100 VIPs. VIPs will be traded on the Exchange. The VIP instrument will not constitute the purchase or sale of any of the component stocks.

One difference between VIPs and the Cash Index Participation (CIP) contract proposed by the Philadelphia Stock Exchange or the Equity Index Participation (EIP) contract proposed by the American Stock Exchange is that short VIPs traders are required to pay longs an "exercise fee" at "cash-out." The exercise fee is designed to "prevent VIPs from trading at a substantial difference to the index value." 53 F.R. 22756. In this regard, the Exchange comments on what it regards as "structural flaws" in the CIP contracts in the Federal Register notice and states:

"This [sic] is no arbitrage mechanism in place to assure that the CIPs price will reflect the value of the underlying securities, and therefore the CIPs might be trading at an even higher premium than [sic] when the market professional thought the initial position was beneficial. The absence of an arbitrage mechanism in conjunction with the perpetual nature of the proposed contracts may lead to a continual building of open interest in the product with market professionals selling CIPs at premiums over the underlying index and purchasing the underlying equities to construct a hedge. As this process continues, a significant proportion of capitalization of all stocks could be "tied up" in CIPs hedges which, though theoretically perfect, are also perpetual.

In addition to this tying up effect CIPs might have on the underlying securities, the short CIPs holder may also be a victim of a "short squeeze." 53 F.R. 22756.

Notwithstanding this difference and the "structural flaws" in the CIP contract asserted by the Exchange, as with the Cash Index Participations proposed by the Philadelphia Stock Exchange and the Equity Index Participations proposed by the American Stock Exchange, the Commission is of the view that the SEC lacks jurisdiction to authorize trading in the VIPs through approval of the Exchange's proposed rule changes because VIPs 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 VIP 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 of 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 VIP 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 VIP contract.

As described above, trading in the VIPs, as we understand the Exchange's proposal, 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. VIPs are agreements for the purchase or sale of a stock index in the future at a price established at the initiation of the contract. VIPs are of "indeterminate" duration so they are not spot contracts. Both parties to a VIP 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.

VIPs have other features that have traditionally facilitated the trading of futures on exchanges. These features include: margin requirements (Rule 25.12); 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 U.S.C. 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,

A handwritten signature in cursive script that reads "Jean A. Webb".

Jean A. Webb
Secretary of the Commission