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

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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 Philadelphia Stock Exchange (Exchange) to trade Cash Index Participations (CIPs) on two stock market indices, published at 53 F.R. 10311, March 30, 1988.

Under the proposals the Exchange defines a CIP as a "security based on the spot value of an index of stocks, of indeterminate duration". Rule 1000B(b). The Exchange's statement of purpose recites that "Investors buying and selling a CIP may realize profits or limit losses on their investment by entering into an offsetting sale or purchase of a CIP in a closing transaction and receive payment of the difference between the price of the purchase or sale and the price at which the closing transaction is effected taking into account transaction costs. In addition, investors buying a CIP may elect to instead realize profits or limit losses on their investment through exercising a cash-out privilege." 53 F.R. 10314. This cash-out privilege is available on the "third Friday" of March, June, September, and December while the contract itself is undated.

Holders of CIPs are entitled to "cash payments equivalent to a proportionate share of any regular cash dividends declared on the component stocks of the underlying index." 53 F.R. 10314. The Exchange proposes CIP contracts on two stock indices, a price-weighted Blue Chip Index of 25 highly capitalized listed common stocks (primarily industrial corporations) and a capitalization-weighted Stock Market Index of 100 of the most highly capitalized, listed, non-ADR, common stocks. The contract size of the Blue Chip Index initially would be priced at approximately $20.00. Similarly, the contract size of the Stock Market Index initially would be priced at approximately $30.00. The standard unit of trading for both CIP indices is proposed to be 100 CIPs. CIPs will be traded on the Exchange. The CIP instrument will not constitute the purchase or sale of any of the component stocks, nor will it confer voting rights, or rights to receive actual dividends connected with the ownership of stock.

The Commission is of the view that the SEC lacks jurisdiction to authorize trading in the CIPs through approval of the Exchange's proposed rule changes because CIPs 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 CIP 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 CIP contract is not an option contract since it obligates both parties to perform at the price agreed to at initiation of the contract, thus fully exposing both parties to potential gain or loss equal to the change of the underlying stock index. With a stock index option contract, the option's strike price establishes a maximum loss from adverse price 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. In addition, there is no apparent option premium paid by the long side of a CIP contract.

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

CIPs have other features that have traditionally facilitated the trading of futures on exchanges. These features include: initial margin requirements (53 F.R. 10313) which are similar to the percentage levels required in currently traded stock-index futures; 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 the Exchange proposal meeting the relevant criteria under the Commodity Exchange Act, including the specific standards for futures on stock indices and be 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