Statement of

James C. Treadway, Jr.

Commissioner, Securities and Exchange Commission

to the

Commodity Futures Trading Commission

Regarding the Application of the
Chicago Mercantile Exchange
For Designation as a Contract Market
For Proposed Futures Contract on
Standard & Poor's Energy Index

December 6, 1983

I thank the Commodity Futures Trading Commission for the opportunity to appear today on behalf of the Securities and Exchange Commission.

In our letter of November 29, 1983, we opposed the Chicago Mercantile Exchange's proposed Standard & Poor's Energy Index future. Over 99 percent of the outstanding market value of the thirty-five stocks in that value-weighted index is attributable to companies in one of the following lines of business: off-shore drilling, crude oil production, integrated domestic or international oil operations, or oil well equipment supply. As discussed more fully below, we believe that such a narrow industry sector does not satisfy an explicit statutory requirement. In addition, in the spirit of the Accord between our two Commissions and as a matter of comity, we request that you carefully weigh the adverse effect upon our regulatory program that may result if you approve the proposed contract.

The Commodity Exchange Act ("CEA")* allows the CFTC to designate a contract market for futures trading on an index or a group of securities only if three tests are satisfied:

(i) settlement of the futures contract is limited to the delivery of cash or exempted securities (other than municipal securities);

(ii) 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 or option on such security, or an option on a group or index including such securities; and

(iii) the index or group of securities is a widely-published measure of, and reflects, the market for all publicly traded equity or debt securities or a substantial segment thereof, or is comparable to such measure.

We note that these three requirements are stated in the conjunctive. Each test therefore is separate, distinct, and of equal legal significance.

---

*Section 2(a)(1)(B)(ii).

Our concerns relate primarily to the third separate requirement, the "substantial segment" test. Neither the statutory language nor the legislative history of the Futures Trading Act of 1982 precisely delineates the scope of the requirement that an index be "broad-based," to use a term that appears frequently in the Act's legislative history. We believe, however, that the "substantial segment" test is more than a reiteration of the Act's anti-manipulation standard set forth in the immediately preceding clause. The "substantial segment" test may reinforce the anti-manipulation standard, but the Act explicitly makes the "substantial segment" test an independent requirement. We believe that the proposed Energy Index future fails to satisfy this test.

We believe that the "broad-based" or "substantial segment" standard serves purposes similar to the CEA's prohibition* against trading futures on individual, non-exempt securities by minimizing the risk that futures trading will disrupt the securities markets or undermine regulation of the securities business, particularly regulation under the Securities Exchange Act of 1934. Among other things, we consider it essential that the "substantial segment" standard be interpreted in a manner that prevents exploitation of the absence of insider trading prohibitions in the commodities laws. Such an opportunity might arise either because the price of the stock to which the inside information pertains has a substantial impact on the value of the index or because the inside information, although relating to a single company, has industry-wide significance. The effect of one company's news on other industry participants was recently demonstrated by the impact of adverse earnings information in December, 1982, upon Warner Communications Corp., a leading manufacturer of video game hardware and software. That information dramatically affected the price of Warner stock and of all other companies in the video game business.

Investing in index futures on the basis of inside information about one company may entail greater market risks than trading that individual stock. Such risks, however, can be substantially reduced by the leverage available to futures traders and the ability to hedge by taking positions in certain other stocks in the index. Perhaps most significantly, the insider is able to proceed confident that he is beyond the reach of the federal securities laws.

We believe that the S&P Energy Index creates a danger of insider trading. The stocks are concentrated in a single industry; the Index is dominated by relatively few securities in that industry, including Exxon, which represents more than 15 percent of the Index; one or more of those securities can act as price leaders for the Index as a whole; thus, the Index magnifies the potential for insider trading. The CEA's "broad-based" requirement was designed to preclude this type of abuse, with its profound adverse effects on investor confidence in both the securities and futures markets.

---

*Section 2(a)(1)(B)(v).

Throughout the consideration of the joint CFTC/SEC legislative recommendations, Congress evidenced substantial concerns about regulatory differences, including margin and many customer protection rules. With those concerns in mind, Congress adopted the "substantial segment" requirement to minimize any possibility that index futures would be used as surrogates for related options or stock trading. Otherwise, the CEA's prohibition against any futures contract based on an individual, non-exempt security could be circumvented or compromised by trading index futures. The SEC's comprehensive regulation of the securities markets could be undermined generally, to the point of becoming irrelevant, by futures contracts that the public or its investment advisers perceive as, for most purposes, adequate surrogates for traditional stock market investments. Moreover, the products themselves would not compete on the basis of economic merit, but on the basis of regulatory differences.

We readily recognize that the CEA gives the CFTC a full and independent regulatory role in the new area of securities index derivative products. We believe, however, that the "substantial segment" requirement is a consciously imposed Congressional requirement designed to ensure that a futures contract will not be a functional alternative to an investment in a given security, thus guarding against insider trading opportunities and ensuring the continued integrity and effectiveness of SEC regulation in our traditional sphere. We believe that approval of the pending contract would undermine that purpose.

Statistical data prepared by our staff indicate a greater correlation between price movements in the S&P Energy Index and stocks composing that index than between those stocks and the S&P 500 index. We concluded, however, that a statistical correlation between an index and an individual security does not demonstrate that an index is sufficiently broad-based. Instead, we believe that Congress intentionally avoided a test based on statistical correlation, inherently an inexact exercise, and created a standard which confined futures based on securities indices to indices that clearly could not be used or classified as surrogates for individual stocks or related options, i.e., indices that are "a widely published measure of, and reflects, the market for all publicly traded equity or debt securities or a substantial segment thereof...." We believe the controlling factor is whether investors and their registered representatives are likely to view the futures index as an apt surrogate for, or alternative to, the purchase of individual stocks. Even in the calculations of a potential insider trader, statistical price correlations over a period of time may not be important. For example, inside corporate information may have industry-wide impact only in particular market situations, or the insider may be able to hedge index risks attributable to companies other than the one to which his information relates.

In the past, the SEC has not objected to futures trading on certain broad economic sector indices. In commenting on the Chicago Mercantile Exchange's Consumer Staple Index proposal earlier this year, our staff concluded that it was a close question whether that index, composed of nine easily distinguishable product groups, satisfied the "substantial segment" test. By contrast, over 99 percent of the value of the S&P Energy Index is attributable to issuers operating primarily in oil and related industries. That is nowhere near the diversity represented by the Consumer Staple Index.

In conclusion, we believe that approval of a futures contract on the S&P Energy Index or on any other essentially single-industry index is inconsistent with the spirit and letter of the CEA and the Accord. We therefore urge the CFTC to decline to designate the Chicago Mercantile Exchange as a contract market for futures on the S&P Energy Index.

I will be pleased to answer any questions you may have with respect to this statement or our comment letter.

* * * * * * *