November 26, 1986

Honorable John S. R. Shad
Chairman
Securities and Exchange Commission
450 Fifth Street, N. W.
Washington, D. C. 20549

Dear Chairman Shad:

I have reviewed your letter of October 21, 1986, which responds to questions raised by the proposal of Security Pacific National Bank to establish and operate a facility for the formalized trading of options on U. S. government securities. Although I fully appreciate your staff's efforts to provide a comprehensive response to my questions, the Commission's memorandum seems to raise as many questions as it answers. In three specific areas, your response either contradicts prior Commission pronouncements or suggests unique, unprecedented approaches to administering the federal securities laws. As a result, as I have indicated before publicly (132 Cong. Rec. H9251 (1986)), during the next session of Congress the Committee on Energy and Commerce may need to consider legislative action on this subject before the Security Pacific proposal becomes operational.

1. Definitional Issue - Is Security Pacific an "exchange" within the meaning of Section 3(a)(1) of the Securities Exchange Act of 1934?

The Commission's response concedes that a literal application of the definition of an "exchange" in Section 3(a)(1) of the Securities Exchange Act ("Act") would find Security Pacific's proposed trading system to be an exchange. Based upon this finding, the Act mandates Security Pacific's registration as a national securities exchange and its compliance with all of the public safeguards for exchanges under the law. As the Commission's response indicates, however, you have chosen to follow a different course.

Rather than apply the statute as written, the Commission has excluded Security Pacific from the definition of an exchange by reading that definition to be limited by the definitions of

market maker, broker and dealer under Sections 3(a)(38), 3(a)(4) and 3(a)(5) of the Act. Regardless of the merit of this interpretation in other contexts, its application to this Security Pacific proposal is misplaced.

Security Pacific's proposed options activities would satisfy neither the market maker definition nor the dealer definition because, as the Commission's response suggests, it apparently is not contemplated that Security Pacific would buy or sell options for its own account. (Of course, if this system will allow Security Pacific to trade opposite customer orders, this market making activity would raise additional regulatory and soundness concerns.) Moreover, the scope of Security Pacific's proposed activities greatly exceeds mere brokerage. Security Pacific has created, fostered and intends to operate and administer a new formalized marketplace in securities. As far as I can determine, Security Pacific will approve the applications of all firms seeking to participate in this market and will enforce the rules and regulations governing transactions executed through this marketplace. In these critical areas, Security Pacific will be acting as an exchange, not a broker. Thus, no apparent statutory basis exists to rely upon the market maker, broker or dealer definitions to exclude Security Pacific from the statutory responsibilities of an exchange.

The Commission also analogizes Security Pacific's planned new market structure to the "blind brokers" that serve the inter-dealer market in government securities. As shown above, Security Pacific's proposed activities extend far beyond blind brokerage. But, even if this analogy was appropriate, it would not justify Security Pacific's exclusion from the exchange definition. As Richard A. Spelke, Senior Vice President of Security Pacific National Bank, has observed, blind "brokers are, in effect, an exchange. They provide the Treasury bond market with the same service that the New York Stock Exchange provides to the equity market." "Big 5 U. S. Securities Dealers," New York Times, June 9, 1983, at D-1.

The Commission also recites the regulatory conditions the no-action letter imposes on Security Pacific. These reporting requirements may well provide valuable information. They are not, however, a suitable substitute for the comprehensive statutory requirements and self-regulatory responsibilities that Congress has imposed upon securities exchanges since 1934 and preserved and strengthened in the Securities Acts Amendments of 1975.

The relative weakness of these Commission-created regulatory conditions is particularly disturbing since Security Pacific has never been called upon to discharge exchange-type self-regulatory duties. For example, in an analogous context, Security Pacific itself has explained in congressional testimony that, in its role

as clearing agent for, among others, Bevill, Bresler, Schulman Asset Management Corp., Security Pacific was "not in a position to provide regulatory oversight and surveillance." Hearing on Failure of Bevill, Bresler, Schulman, a New Jersey Government Securities Dealer, Hearing Before the Subcommittee on Commerce, Consumer and Monetary Affairs of the House Committee on Government Operations, 603 (1985) (Statement of Charles M. Viviano, Managing Director, Security Pacific Clearing & Services Corp.). See also "Regulators Are Not Likely to Overhaul Clearing of Government Securities Trades," The Bond Buyer, Monday, May 20, 1985, regarding the roles of Bradford Trust Co. and Security Pacific Clearing & Services Corp. in the failures of Bevill and E.S.M. Government Securities Inc. and the failings of the so-called "omnibus clearing" arrangement:

> . . . the main shortcoming of the omnibus system is that it lacks the safeguards needed to prevent dealers from fraudulently pledging the same securities against several different transactions.
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> And as it works now, 'The clearing agents simply don't want to know' the status of a dealer's accounts with its customers, said a high-ranking federal bank regulator. 'The less knowledge they have the less liability they have.'
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> 'A clearing bank is not in a position to police the various types of transactions between its clients and the entities with which such clients do business.' Thomas J. Perna, Fidata's president, said in congressional testimony last week.

Accordingly, the Commission's apparent attempt to replace congressional mandates with agency constructs does not appear to be well grounded in either law or public policy. I urge you again to reconsider the Commission's approach to this matter.

2. Will the Security Pacific market trade standardized options?

The Commission's response also stated that "the Security Pacific proposal does not involve the issuance of standardized options as defined in Rule 9b-1." (Response at 4.) In the Commission's view, the absence of standardized options seems to justify reduced public disclosures about the Security Pacific options system in the Form S-1 to be filed for these securities.

Your statements, however, are inconsistent with your prior statements and those of Security Pacific. On September 25, 1986, you wrote to me expressing support for the clearing agency

provisions of H.R. 2032, the Government Securities Act of 1986. On page 5 of your supporting statement, the Commission explained that Security Pacific had "announced plans to issue, clear and settle standardized options on U. S. government securities that will be traded through an automated quotation system operated by an affiliate of Security Pacific." (Emphasis added.) In a July 1985, Background Information Statement (page 5), Security Pacific itself explained that there "will be minimum standardization" of options traded through this system. Security Pacific further explained that the system will require monthly expiration cycles, strike prices in 1 and 2 point increments, and trading in only U. S. government securities with multiples of a million dollars.

I recognize that the definition of standardized options in Rule 9b-1 contemplates exchange trading of these options. Rule 9b-1 thus confirms my understanding that long-standing and sound SEC policy has required trading of all standardized options through the facilities of self-regulatory organizations. Commission reliance on the absence of exchange trading to weaken public disclosures for the otherwise standardized options to be traded by Security Pacific would be disingenuous, at best. Security Pacific's standardized options should be treated like all other standardized options.

3. Is the potential invalidity of Security Pacific options a matter of private concern or public disclosure?

The Commission's response suggests that Security Pacific need not include in the prospectus for its options any disclosure relating to the possible voidability of these options. The response describes this as a matter of "private concern" to be addressed "if the issue is contested."

To the contrary, the issue whether Security Pacific's options must be traded on exchanges is an issue of public concern. Prospective participants in the Security Pacific system are entitled to know the issuer's views on the validity of the options and the possible remedies available if the options are found to be invalid. In addition, the public should be advised of the risks created by Security Pacific's deviation from the congressionally approved regulatory scheme for trading standardized options. The possibility of congressional action in this area also should be disclosed.

These are not academic or hypothetical issues; the legitimacy of the Security Pacific system has been questioned by many Members of Congress in letters to the Commission and investors should be fully apprised of all material information concerning these issues before deciding whether to participate in Security Pacific's system.

Again, I appreciate the efforts of the Commission and its staff to respond to the difficult and serious issues raised by this proposal. I urge the Commission to reconsider this matter at the earliest practicable time, and I look forward to receiving your response.

Sincerely,

JOHN D. DINGELL
CHAIRMAN

cc: Honorable Fernand J. St Germain
Honorable Norman F. Lent
Honorable Paul A. Volcker