



UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

THE CHAIRMAN

March 12, 1991

The Honorable Richard G. Darman
Director
Office of Management & Budget
725 17th Street, N.W.
Washington, D.C. 20502

Dear Mr. ~~Darman~~ *Dick*:

Thank you for your memorandum, dated March 8, 1991, requesting the views of the Securities and Exchange Commission ("SEC") on S.207, a proposed amendment to the Futures Trading Practices Act of 1991. S.207 addresses both the issue of margins on stock index futures and the scope of the so-called "exclusivity clause" of the Commodity Exchange Act ("CEA"). We note that the margin language of S.207 is considerably weaker than either the Administration's proposed legislation of last year or the margin proposals contained in the Intermarket Coordination Act of 1991 introduced by Senator Leahy (the "Compromise Bill"). Nevertheless, while we believe that the stronger language of the Compromise Bill would be preferable, we defer comment on the margin proposals.

For the reasons described below we believe that the proposed provisions concerning exclusivity¹ would be extremely bad public policy, and must either be significantly improved or removed entirely from the legislation. Unless modified, the proposed treatment of the "exclusivity" clause would in our view be considerably worse than continuation of the status quo. Indeed, by codifying the most expansive definition of exclusivity, subject only to the ephemeral possibility of occasional exceptions or exemptions at the sole discretion of the CFTC, the language of the bill would constitute legislated domestic protectionism. As a result, most new "hybrid" securities products would be prohibited or driven offshore. In addition, the \$3 trillion index options market would apparently be transferred to CFTC oversight. Most swaps business would be driven to foreign markets, and what remained in the U.S. would

¹We first saw the proposed language last Wednesday following the mark-up of the Senate Agriculture Committee. No hearings have been held on this proposed language, which we believe could have a serious and long-lasting negative impact on the nation's securities markets.

operate under crippling conditions. Even demand deposit accounts at banks would implicitly be regarded as subject to assertion of exclusivity -- though the CFTC would have less discretion to abolish deposit products than swaps or securities hybrids.

As we have previously testified, the Securities and Exchange Commission believes that increased competition and innovation within the financial markets are critical to future economic growth and prosperity. Wherever possible, our laws should allow securities and futures instruments to be offered to investors free of arcane and unnecessary restrictions. Low cost capital can be achieved by minimizing regulatory hurdles, litigation and uncertainty as to the lawfulness of innovative forms of securities and futures instruments. Sadly, the so-called "exclusivity clause" of the CEA currently restricts significantly the offering of new products. The Administration has consistently proposed to eliminate this impediment to capital formation. Unfortunately, although S.207 purports to further these goals, in fact -- as currently drafted -- the bill will stifle competition and crush innovation.

As currently written, S.207 codifies into law the position that all financial instruments that the CFTC determines to include any degree of "futures" must be exclusively traded on futures exchanges unless a product (i) meets an unrealistic mathematical test of the degree to which an instrument's "value" is based on a commodity, or (ii) receives a written exemption from the Commodity Exchange Act from the CFTC. While the bill provides the pretense of fairness through its "50% value" test, that test is misleading. Since only the CFTC would decide when an instrument's "value" is tied to a commodity, and since under the CFTC's existing analysis, new equity products with characteristics of both futures and securities always are viewed as 100% futures, in fact there will not ever be any equity-related hybrid that the CFTC would concede meets the requirements for the 50% exception. In effect, for the first time in history, the SEC would be denied the right to define what is a security, and this function will be solely conferred on the CFTC.

Under S.207, the CFTC would be entitled, but not required, to allow the trading or sale of "any agreement, contract or transaction ... either unconditionally or upon stated terms or conditions or for stated periods ..." Exemptions "may" be granted where the CFTC decides "that such exemption would be consistent with the public interest." Although the legislation appears to give the CFTC wide exemptive power, essentially all financial products would remain illegal until proven otherwise. In addition, S.207 would prohibit the CFTC from granting an exemption unless an applicant proves the existence of at least five factors "to the satisfaction of" the CFTC.

The anticompetitive intent of S.207 is demonstrated by an incredible provision that requires a would-be competitor to demonstrate that there will not be any "material adverse effect ... on the ability of ... any contract market to discharge its ... self-regulatory duties" This appears specifically designed to allow futures exchanges to veto any exemption for a product that would compete with their own. No standards for the showing of harm to one of the futures exchanges are set forth in the language. Harm to the securities exchanges is never measured or considered, though they are the source of capital for much of American business.

We believe that the language of S.207 should be revised to permit clearly and unequivocally the development of innovative securities products. In order to encourage competition and innovation, if the SEC determines that more than 50% of the features or characteristics of a product are those of a security (even if that product has some elements of a futures instrument), it should be exempt by statute from the exclusivity clause, so that the product would be eligible for trading in the U.S. securities markets. Similarly, if the CFTC determines that 50% or more of the features or characteristics of a given product are those of a commodity futures contract, that product should be free to trade on a commodity exchange, even though the product has some elements of a security. The SEC has supported such an approach for more than a year.

Discussed below are certain of our major concerns with the proposal.

1. Hybrid Commodity Instruments

As currently drafted, the hybrid commodity instrument exemption would chill the development and introduction of new hybrid securities products. As drafted, the "50% value standard" depends, among other things, upon (1) what options pricing model is selected, (2) what volatility factor is assumed, and (3) whether there is a ready market by which to compute the value of the options or futures component. Moreover, the 50% value standard is not useful in analyzing innovative new products such as index participations that have characteristics of both securities and commodity options or futures. Under the analysis employed by the CFTC in the past, such products would always fail the 50% test, even though their predominant features are those of a security.

A more relevant test for the statutory language would be whether 50% or more of the "characteristics" of an instrument, not its "value," are those of a commodity or those of a security. For an equity product, mathematical computations of "value" measure only one limited aspect for determining whether or not

the instrument is predominantly a security. Accordingly, any "50% test" should be based on all "characteristics" of the instrument, not simply one of many characteristics.

More broadly, we believe that any 50/50 test for allowing trading rights should provide that an instrument could be traded in the securities markets if "the instrument is determined by the Securities and Exchange Commission to have at least 50 % of its value or characteristics derived from elements of a security as defined under Section 3(a)(10) of the Securities Exchange Act of 1934 or Section 2(1) of the Securities Act of 1933."

2. Exemptions for Index Participations

The exemption for Index Participations ("IPs") exempts only IPs that were approved for trading prior to April 11, 1989, or pending such approval on or before December 31, 1990. This provision simply creates an exemption for six IPs. All future IPs proposed by any of the nation's securities exchanges or by the National Association of Securities Dealers ("NASD") for NASDAQ trading would be forbidden, as would any successor products to the existing six IPs.

This anti-competitive restriction would lead to ludicrous results. For example, under the terms of this provision, only four securities exchanges would trade IPs, as only those exchanges had proposals to trade IPs included in the SEC's April 11, 1989 order or pending before the SEC by December 31, 1990. All other securities exchanges, including the Boston Stock Exchange, Pacific Stock Exchange, Midwest Stock Exchange, and Cincinnati Stock Exchange, as well as the NASD would be precluded from ever trading IPs. It would be equally ludicrous to allow IPs on the Standard & Poor's 500 Index, because it had been approved by the SEC, but not on other stock indexes that the SEC would also approve, such as the Value Line index or indexes on foreign stock markets, such as on the Japanese or British markets. Nonetheless, this is the utterly unjustifiable result of the express terms of this bill. Moreover, the bill would freeze in place all specifications of IPs, so that no useful refinements could be made in the future. For example, previous IPs provided for quarterly pass-through of dividends to the holders of IPs, but the bill would prevent an exchange from proposing a monthly pass-through of dividends. We see absolutely no reason for such extreme limitations other than pure domestic protectionism.

To ameliorate these concerns, the bill's version of Section 4c(f) of the CEA should provide that any IP approved by the SEC

would be exempt from the CEA.² This would be entirely consistent with the bill's intent of letting this useful and innovative product, which had volume of over 70 million IPs before it was abolished from the market by litigation, freely trade on a securities market. In addition, the section should specifically state that IPs are not considered futures.

3. Impact on SEC Jurisdiction

Rather than simply resolving the existing uncertainty over the legal status of new products, the proposal raises serious questions concerning the Commission's current authority under the federal securities laws. Indeed, the bill may be read to give the CFTC jurisdiction over stock index options, other stock index products, and, perhaps, options on individual securities. This would represent a massive transfer of the SEC's existing jurisdiction -- that in some cases we have exercised since 1934. Trading in index options alone last year aggregated \$2.9 trillion, yet this activity on the Chicago Board Options Exchange, American Stock Exchange, New York Stock Exchange, Philadelphia Stock Exchange and the Pacific Stock Exchange would quite possibly become unlawful under the language of the bill. Aside from its regulatory implications, this would require significant staffing and budgetary increases for the CFTC, an agency that does not offset its costs by fees as does the SEC.

Section 4c(g)(B) would give the CFTC jurisdiction over any transaction "in or involving a commodity" not exempted under the bill. Since a "commodity" includes all goods and services in the world except onions, this would appear to cover any products "involving" stock indexes. Depending on the construction of the term "involving," it could also encompass options on the individual stocks comprising those indexes, or even the underlying securities themselves. Although the securities laws currently contain a provision explicitly giving the Commission jurisdiction over options, the fact that this proposal would be enacted subsequently could raise questions about the continued validity of the earlier provision. Such a result is clearly at odds with any responsible effort to clarify the scope of the CFTC's exclusive jurisdiction, and Section 4c(g)(B) should be deleted from the proposal in its entirety.

Under the Administration's bill, S. 2814, the philosophy was to permit competition and innovation wherever possible. The current language is designed to do exactly the opposite by restricting innovation and competition in virtually every imaginable case. We would strongly support a true 50% test: if

² This would be accomplished by ending Section 4c(f)(2) after the word "Commission".

the SEC finds a product 50% or more a security, it could be traded on a securities exchange. If the CFTC finds a product 50% a future, it could be traded on a commodity exchange. If both agencies made such a finding, the products could trade on both types of exchanges. Long and expensive regulatory proceedings would not be necessary and competition would be maximized. We believe that this is entirely consistent with the President's express position on S. 2814, as well as his longstanding commitment to minimize, not maximize, regulatory restrictions on competition.

4. Impact on Swaps

S.207 also sets out narrow exception and exemptive provisions for swap contracts which would have a devastating effect on that market. While the exclusion may be intended to provide certainty, its limitations dramatically undermine its effectiveness. Specifically, the exclusion requires that any person entering into a swap agreement do so only to hedge or manage a business-related price risk. This requirement ignores the nature of the market and makes the exclusion unavailable to banks and other swap dealers. The exemptive provision is equally ineffective because it gives the CFTC complete discretion to grant no exemptions at all. Moreover, the substantive requirements for any exemption are extremely restrictive, limiting swaps to institutional participations and where the creditworthiness of each party to the swap agreement would be a material term of the negotiation of the swap agreement. Finally, any efforts to improve the efficiency and liquidity of the swap market through developing a trading market would destroy the exemption. The inevitable result of these provisions will be to drive most swaps offshore and to hamper severely the operation of any market remaining in the U.S.

The specific statutory language changes we propose are included in Exhibit A, with additions underlined and deletions [bracketed].

Sincerely,



Richard C. Breeden
Chairman

EXHIBIT A

SEC. 303. HYBRID COMMODITY INSTRUMENTS.

Section 4c of the Act is amended by adding a new subsection (g) to read as follows:

"Sec. 4c(g) "(A) Notwithstanding any other provision of law, [n]othing in this Act shall be deemed to govern or in any way be applicable to any transaction which meets the following requirements--

"(1) to the extent that the instrument has elements of a commodity option, less than 50% of its characteristics are those of a commodity option, or the instrument derives less than 50 percent of its value at the date of issuance from the value of the commodity option, and

"(2) to the extent that an instrument has elements of a contract of sale of a commodity for future delivery, less than 50% of its characteristics are those of a contract of sale of a commodity for future delivery, or at the date of issuance it is expected that less than 50 percent of the change in the value of the instrument or its performance will be due to movement in the price of the commodity or commodities specified in the instrument or in the terms and conditions of the transaction pursuant to which the instrument was issued, or

"(3) the instrument is determined by the Securities and Exchange Commission to have at least 50% of its value derived from or 50% of its characteristics attributable to the elements of a security, as defined under Section 3(a)(10) of the Securities Exchange Act of 1934 or Section 2(1) of the Securities Act of 1933, or a group or index of securities; provided that this clause (3) shall not apply to transactions conducted on a designated contract market involving contracts of sale of a commodity for future delivery (or options thereon) or accounts and agreements related to such transactions.

["(B) Any transaction in or involving a commodity regulated under this Act not excluded by paragraph (A) above shall be subject to regulation by the Commission under sections 2(a)(1), 4, 4c or 19 of this Act."]

SEC. 304. INDEX PARTICIPATIONS

(a) Section 4c(f) of the Commodity Exchange Act (7 USC 6c(f)) is amended to read as follows:

"(f) (1) Nothing in this Act shall be deemed to govern or in any way be applicable to any transaction in an option on foreign currency traded on a national securities exchange.

(2) Nothing in this Act shall be deemed to govern or in any way be applicable to any contract traded on a national securities exchange or quoted through an automated inter-dealer quotation system operated by a securities self-regulatory organization whereby any party to the contract acquires any interest in a stock index participation unit approved for trading by the Securities and Exchange Commission, and such stock index participation unit shall not be a contract of sale of a commodity for future delivery. [by order dated April 11, 1989, or pending such approval on or prior to December 31, 1990.]

"(3) The Commission shall utilize its existing authority under this Act to facilitate the registration of any person who is a 'person associated with a broker or dealer' or 'associated person of a broker or dealer,' as those terms are defined in section 3(a)(18) of the Securities Exchange Act of 1934, for the purposes of marketing stock index futures (or options thereon) to the public."