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August 11, 1986

CHAIRMAN'S OFFICE

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SEC. & EXCH. COMM.

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

Dear Mr. Chairman:

Thank you for testifying before the Subcommittee on Commerce, Consumer and Monetary Affairs on July 23, 1986, on the regulation of financial services. I would greatly appreciate your response to certain questions outlined in this letter, which follow from the hearing, so that they might be provided as part of the record.

Clarification I

I would appreciate a clarification of your testimony to assure the Committee that the thorough regulatory protection provided for under the Securities Exchange Act will be followed regarding Security Pacific's proposed option market. Can you assure me that no approval by the SEC will occur that would permit the operation of a market which functions like an exchange without registering with the SEC as an exchange and satisfying the regulatory safeguards provided by that Act.

As we discussed at the hearing, I trust the SEC's ultimate approach on this matter will follow the traditionally accepted standards for ensuring regulatory safeguards on exchanges which conduct public markets in options. It is my view that the "No-action" letter issued by the SEC staff on July 19, 1985, is an extraordinary departure from SEC practice, but one which the Commission can and should correct. As you know, the Congressional approach to option trading has been one of caution with restrictive pilot programs and substantial agency and congressional oversight. I believe traditional regulatory safeguards on exchanges which conduct public markets in options are imperative.

### Clarification II

Please clarify Mr. Richard Ketchum's testimony that the Johnson/Shad Accord of 1982 intended that options on over-the-counter securities would be outside the scope of the normal registration process.

The joint SEC/CFTC jurisdictional amendments in 1982 changed the definition of "security" to make it clear that options are securities for purposes of the securities laws, and also made it clear that the SEC's extensive power to regulate securities options trading was intended by Congress to extend to exempted securities. The addition of Section 9(g) made it clear that only the SEC had the authority to exercise such regulatory powers. In enacting those provisions, it is clear to me that Congress intended that the SEC should exercise full its regulatory authority under the Act with respect to standardized options on exempted securities. The SEC's record to date confirms this.

I call your attention to the legislative history supporting this. The reports of both the Senate Banking Committee and the House Energy and Commerce Committee stressed that it would be appropriate for the SEC to treat "certain over-the-counter options" as exempted securities and to grant exemptions to government securities dealers in the case of "non-standardized or conventional options." Neither committee indicated that it intended the SEC to narrow the statutory definition of exchange" or to expand the Section 5 exemption from exchange registration. Further, the House report stated "that, when traded on a national securities exchange..., all options will be subject to registration and prospectus delivery requirements comparable to those applicable to exchange-traded options on equity securities." House Report No. 626, Pt. I, 97th Cong. (1982) at 12.

In short, it seems quite clear that while Congress expected exemptions could occur for "non-standardized or conventional options," Congress clearly did not anticipate that exchange-traded options would be exempted by permitting the exchange on which they were traded to be unregistered. Thus, please clarify Mr. Ketchum's testimony on this point.

### Clarification III

Please review the relationship of the pending Government Securities Dealer Act to the proposed Security Pacific market. Mr. Ketchum stated that the pending legislation would alleviate my concerns because it would require dealers trading government securities through a proposed Security Pacific market to register with the SEC as government securities brokers or dealers unless they were already regulated as securities brokers-dealers, financial institutions, or primary dealers. However, the context of my question was quite different. My concern goes beyond having the participants register as broker-dealers; rather, my concern is that the Security Pacific market should be required to register as an exchange.

My overriding concern is that the integrity of markets be ensured. Ensured not only with respect to the integrity of member brokers, but ensured as to the integrity of the exchange. I am unaware of any provisions in the pending Government Securities Dealer Act that would ensure the integrity of the proposed exchange. I would appreciate your clarification on this point, as I believe the public protection available flows only from the applicability of the current SEC regulatory scheme.

#### Clarification IV

I would appreciate your clarifying what government regulatory structure exists or would be provided to ensure the financial integrity of any guarantor for the proposed Security Pacific exchange.

At the hearing we discussed the importance of ensuring the financial stability of the proposed Security Pacific market. As you know, in its initial submission Security Pacific proposed serving as the opposite party to each option issued in its market. This seems to have the frightening potential of placing the entire capital of the bank at risk in order to guarantee performance for market participants on its proposed options exchange. Mr. Ketchum stated that this similar concern had also been raised by the Comptroller of the Currency and the Federal Reserve Board. Mr. Ketchum indicated a guarantor, such as a major insurance company, might be provided.

However, my concern remains. It simply shifts to the financial integrity of the guarantor, and what regulatory structure exists to oversee it.

#### Clarification V

It is my understanding that the Market Regulation staff may be presenting proposed rules to the Commission which would create a new category of registration for an electronic exchange market, such as the Security Pacific proposal. Can you assure me that Security Pacific, or any other entity, will not be permitted to commence a proposed market until these proposed rules have completed the full administrative law process, including public comment, thorough and complete airing and evaluation of the public comments, presentation of revised rules, and final adoption (if they are adopted) of the rules by the Commission.

#### Conclusion

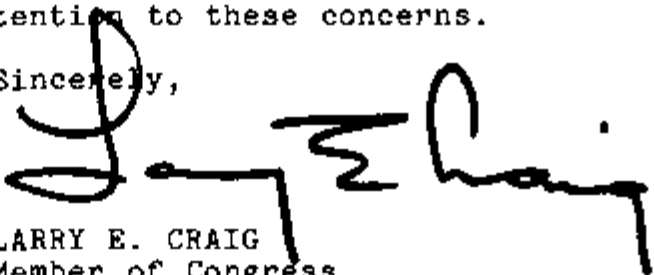
Finally, Chairman Shad, I want to commend your recognition that public policy is ill served when competing products operate such that one is permitted to operate in a less regulated environment than the other.

It is my belief that the Congressional view in recent years has been to call for greater regulation of the government securities markets, not less. As you well know, we have seen a series of highly publicized frauds and financial defaults such as Drysdale, Beville Bressler, and ESM. These bolster my view that regulatory safeguards on exchanges which conduct public markets in options on government securities are imperative.

Your response to this letter would be greatly appreciated. Please respond by August 20, 1986, so that it may be incorporated in the hearing record of July 23, 1986.

Thank you for your serious attention to these concerns.

Sincerely,



LARRY E. CRAIG  
Member of Congress

c.c. Chairman Doug Barnard