



TESTIMONY OF

**RICHARD R. LINDSEY, DIRECTOR
DIVISION OF MARKET REGULATION
U.S. SECURITIES AND EXCHANGE COMMISSION**

**REGARDING
H.R. 467, THE COMMODITY EXCHANGE ACT
AMENDMENTS OF 1997**

**BEFORE THE SUBCOMMITTEE ON RISK MANAGEMENT AND
SPECIALTY CROPS
COMMITTEE ON AGRICULTURE**

U.S. HOUSE OF REPRESENTATIVES

APRIL 15, 1997

U. S. Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549

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Chairman Ewing and Members of the Subcommittee:

The Securities and Exchange Commission ("SEC" or "Commission") appreciates the opportunity to express its views on H.R. 467, the Commodity Exchange Act Amendments of 1997. As the Commodity Futures Trading Commission ("CFTC") noted recently, periodic review of the Commodity Exchange Act ("CEA" or "Act") is an appropriate means for addressing changes in the futures and options markets regulated under the CEA. The 104th Congress completed a review of the federal securities laws and enacted the National Securities Markets Improvements Act of 1996,¹ which granted the SEC broader exemptive authority, giving it the necessary flexibility to better address changing market conditions. The SEC, therefore, has an appreciation for many of the goals reflected in H.R. 467 and shares with the CFTC an interest in ensuring that legislative proposals that affect the nation's financial markets also preserve market integrity.

¹ P.L. 104-290; 110 Stat. 3442 (1996).

As further detailed in this written statement, the SEC supports efforts to clarify the scope of the Treasury Amendment. However, the SEC does not support the professional market provisions contained in the bill. As drafted, the bill would exempt both exchange and OTC transactions from regulation under the CEA, with the exception of the antifraud and antimanipulation provisions of the Act. As it applies to exchange transactions, the proposed exemption would expose futures markets to additional risk of manipulation, call into question the validity of the exchanges as price discovery mechanisms, and place undue pressure on clearing mechanisms for both professional market and retail market transactions. These provisions also would undermine the SEC's ability to regulate trading and detect fraud in the various securities underlying the futures and options to be traded in the professional markets, and would fundamentally alter the existing jurisdictional balance between the SEC and the CFTC that is reflected in the Shad-Johnson Jurisdictional Accord.²

² The jurisdictional agreement, commonly referred to as the "Shad-Johnson Accord," was passed into law as part of both the Securities Acts Amendments of 1982 and the Futures Trading Act of 1982. See P.L. No. 97-303; 96 Stat. 1409 (1982) and 97-444; 96 Stat. 2294 (1982). Under the Shad-Johnson Accord, the CFTC retained exclusive jurisdiction over all futures contracts, including futures contracts on stock indices and options on futures contracts and physical commodities. The SEC, however, was given a special consultative and concurrent role in the approval process concerning stock index futures contracts. Accordingly, no stock index futures contract may be approved unless the SEC determines that it satisfies three criteria, specifically, that settlement or delivery on such contract be in cash or by means other than the transfer or receipt of a security (other than an exempted security), that trading in such contract not be readily susceptible to manipulation, and that the index be a broad-based index predominately composed of the securities of unaffiliated issuers and that it be a published measure reflecting the market for all publicly traded equity or debt securities or a substantial segment of such market. Under the Accord, the SEC also retained jurisdiction over securities, including options on securities (including exempted securities), options on certificates of deposit, options on stock indices, and options on foreign currency traded on a national securities exchange. Futures contracts on individual securities, other than exempted securities, are prohibited.

With respect to OTC transactions, the SEC supports legislation that would enhance legal certainty for privately negotiated, institutional transactions in the over-the-counter ("OTC") derivatives markets that have developed and grown outside the scope of existing CFTC regulation. The SEC, however, recommends an alternative approach for achieving this goal.

Professional Market Exemption. The professional market exemption proposed in Section 102 of the bill raises significant concerns for both exchange and OTC markets. As applied to organized, public exchange markets, a broad exemption from regulation under the CEA could seriously impair market integrity in both futures and securities markets. Concerns, however, are different regarding the application of the exemption to an OTC market characterized by privately negotiated contracts between institutional customers. Here, the Commission's concerns stem mainly from the broad exemptive approach taken by the bill.

Exchange Markets. With a few exceptions, the CEA requires that futures contracts be traded on a futures exchange, subject to the regulatory requirements under the CEA. The professional market exemption in Section 102 of the bill generally would exempt from most CEA provisions exchange trading among so-called "appropriate persons," subject only to the CEA's antifraud and antimanipulation provisions. We understand that it is estimated that approximately 90% of the volume of trading now taking place on futures markets thus would become eligible to trade in a largely unregulated environment. Futures exchanges argue that this exemption is necessary, notwithstanding increasing exchange-trading activity, in order for exchange markets to compete with burgeoning OTC markets. They cite as evidence their belief that market participants are attracted to OTC markets because of lower regulatory costs. While it is true that OTC markets are growing, there is no evidence to prove that lower regulatory

costs are the reason. Instead, as market participants become more sophisticated in their ability to identify and hedge risks, individually negotiated, customized OTC products may prove to be better risk management tools in many instances than standardized exchange-traded products. Moreover, futures exchanges have benefitted from the growth in OTC derivatives markets as OTC dealers hedge their risks using exchange-traded products.

The professional market exemption would result in a dangerous and unprecedented restructuring of exchange markets into a two-tiered system that turns a blind eye to certain fundamental differences between exchange and OTC markets, and the crucial role exchanges play as price discovery mechanisms. First and foremost, exchanges are organized *public* marketplaces. In contrast, the OTC derivatives marketplace involves *privately negotiated* contracts between institutional customers, warranting a different framework for, and level of, regulation.

Exchange marketplaces centralize market activity by bringing together buyers and sellers, thereby promoting liquidity for market participants. Regardless of sophistication and level of assets under management, traders need accurate information about quotes and last sale prices. Further, a two-tiered market in which 90% of all trading occurs in a separate, unregulated environment would seriously impair market liquidity for small business and retail participants in the non-professional market, making it harder for them to buy and sell at fair prices. While this smaller exchange market would have the full protection of CFTC regulation, it would lose the economic benefits of being an active, deep, liquid market.

Exchanges also provide centralized environments that facilitate price discovery. In theory, market prices are determined in accordance with the free market forces of supply and

demand. In reality, market participants can manipulate the price discovery function by purposefully altering demand or by reducing, or "squeezing," the supply of a commodity available to the market. Typically, only large market participants are capable of successfully manipulating markets. Yet, under the proposed professional market exemption, trading by these large market participants would not be subject to audit trail, books and records, and surveillance requirements that are essential in uncovering, and thereby deterring, fraud and manipulation. Moreover, a substantially deregulated professional market would hinder the SEC's ability to surveil for fraud in the underlying securities.

Proponents of the exemption argue that deregulation should not be a concern because the CFTC would retain antifraud and antimanipulation jurisdiction over professional markets. The CFTC, however, would be removed from routine oversight and surveillance of the professional markets, making it harder for the agency to detect fraud and manipulation. Eliminating appropriate CFTC regulation of these markets also would impair price transparency, increasing the potential for unfair or anticompetitive market practices. In addition, the market would lose the benefit of the CFTC's financial protection rules, thus increasing the possibility of an unexpected financial failure by an individual market participant and the concomitant risk of such a failure destabilizing the futures markets and related financial markets.

Proponents of the exemption claim that self-regulation is sufficient for the maintenance of fair, orderly, and stable markets. Although self-regulation plays an important role in the supervision of market participants, it is also susceptible to inherent conflicts of interest. Self-regulation alone cannot guarantee market integrity.

Some of the conflicts that can arise in self-regulation were described recently in a report

of the SEC regarding the National Association of Securities Dealers, Inc. ("NASD") and the Nasdaq market.³ This report describes abuses by market makers in the Nasdaq market and acknowledges that these market makers were able to exert substantial influence over the affairs of the NASD through their role in the NASD's governance structure.⁴ Abuses also have arisen in commodities markets, as illustrated by the 1989 FBI sting operation involving Chicago exchanges. Awareness of these potential conflicts is not new. In fact, they were well understood by the drafters of the Securities Exchange Act of 1934 and the authors of the Securities Industry Study in the early 1970s.⁵

³ See Report Pursuant to Section 21(a) of the Securities Exchange Act of 1934 Regarding the NASD and the Nasdaq Market, Securities and Exchange Commission, Aug. 8, 1996 ("21(a) Report").

⁴ Id. at 35. The Commission's 21(a) Report reminded the NASD of its role as a self-regulatory body. According to the report:

The NASD, like any regulator, must be cognizant of the natural tendency of a regulated industry to influence its regulator to protect the industry's proprietary interests. As an SRO, the NASD must guard against the efforts of any one segment of its membership, such as its market maker members, to assert undue influence over its regulatory functions and processes. While the NASD's market maker members have a significant and appropriate role to play in the self-regulatory process governing the Nasdaq market, the public interest must be the predominant concern. Id.

⁵ The 1973 Securities Industry Study, a report of the Senate Subcommittee on Securities, Committee on Banking, Housing and Urban Affairs ("Study"), evaluated self-regulation in the securities industry. According to the Study:

The inherent limitations in allowing an industry to regulate itself are well known: the natural lack of enthusiasm for regulation on the part of the group to be regulated, the temptation to use a facade of industry regulation as a shield to ward off more meaningful regulation, the tendency for businessmen to use collective action to advance their interests through the imposition of purely anti-competitive restraints as opposed to those justified

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Because the proposed professional market exemption is written so broadly, it would include equity-based products, including futures on single equity securities and narrow-based indices, that are the subject of the Shad-Johnson Accord. The exemption, therefore, would vitiate the Shad-Johnson Accord and unnecessarily erode Commission oversight of markets for equities and equity derivatives. Thus, the risks to market integrity posed by the professional market exemption raise concerns not just for commodities markets, but also for securities markets.

During the past two decades, the Commission has witnessed the proliferation of new financial products. Many of these are securities-based products, including options on securities indices that are traded in securities markets, and futures on securities indices that are traded on futures markets. These securities-based derivative products are fungible and can be used by dealers and traders to hedge risks and maximize trading returns. These products are important to the functioning of our markets today, but we must remember that there are dynamic and sometimes complex interactions between the futures, options, and cash markets. The Brady Report and the SEC staff report on the October 1987 market break describe how trading in the futures market influenced, and was influenced by, exchange trading involving both the cash market and option products.⁶ It is precisely because futures and securities markets are linked

⁵(...continued)

by regulatory needs, and a resistance to changes in the regulatory pattern because of vested economic interests in its preservation. S. Rep. No. 13, 93d Cong., 1st Sess. 145 (1973).

⁶ See Report of the Presidential Task Force on Market Mechanisms (1988), pp. 55-57 ("Brady Report"); The October 1987 Market Break, A Report by the Division of Market Regulation, SEC (1988), pp. 3-3 through 3-17.

that the SEC is concerned that undetected fraud and manipulation in futures markets, or financial instability among futures market participants, would inevitably spill over into the nation's securities markets, and pose systemic risks for the broader financial markets.

The professional market exemption also is likely to undermine the integrity of clearinghouse mechanisms and the ability of clearinghouses to service firms that represent small and retail customers. Currently, futures clearinghouses, with the financial backing of their member clearing firms, provide certainty and stability to the futures markets by acting as counterparties in each exchange transaction. As a result, market participants can be confident that trades will be successfully settled and cleared. However, it is doubtful whether funds related to regulated and unregulated trading should be commingled in the same clearinghouse because of public policy concerns raised by subjecting funds relating to the regulated market to the risks of trading in unregulated markets.

An alternative would be to create a two-tiered clearinghouse system that would service a two-tiered market. The bill would permit the creation of such a two-tiered system and would require that any clearinghouse or clearing system used by the professional market be approved by the CFTC. Under this two-tiered system, clearinghouses serving the professional market would assume responsibility for settling and clearing trades in a largely unregulated market subject to greater risks of fraud and manipulation. Without active CFTC supervision and oversight of the professional market, and without the implementation by clearinghouses of appropriate standards for financial responsibility and other trading safeguards, problems of the magnitude seen in recent trading scandals involving Barings, Sumitomo, or Metallgesellschaft could profoundly affect clearinghouse integrity in the event that a firm cannot honor its trades.

Small clearinghouses charged with clearing trades by small and retail investors would also be at risk because they would lack the economies of scale necessary for cost-effective operation. Small investors, therefore, in addition to losing the benefits of a deep, liquid market, would assume the risk that their trades would no longer be settled and cleared in an efficient and cost-effective manner.

As an alternative to the professional market exemption contained in H.R. 467, the SEC would recommend that the CFTC continue to work with major U.S. futures exchanges on the development of the professional market pilot program adopted by the CFTC in 1995.⁷ The use of a pilot to develop a suitable model for the operation of professional markets would allow both the CFTC and the futures industry to strike a careful balance between CFTC oversight and deregulation. In adopting the professional market pilot, the CFTC recognized that greater flexibility in trading practices and streamlined procedures for CFTC review of contract market rules would be appropriate for futures trading involving a class of institutional market participants. Yet, the careful approach suggested by the pilot acknowledges the significant role exchanges play in price discovery and in providing liquid markets for all investors, not just large investors. Indeed, appropriate levels of regulation can help markets grow by assuring market participants that markets are stable, fair, and liquid.

In contrast to the pilot, which would preserve the provisions of the Shad-Johnson Accord and its prohibition against futures on single securities and narrow-based indices, the professional market exemption would vitiate the Shad-Johnson Accord and upset the carefully negotiated regulatory balance between the SEC and the CFTC. The prohibition on futures on individual

⁷ See 60 FR 51323 (Oct. 2, 1995), adopting 17 C.F.R. Part 36.

stocks arose out of concerns that if the CFTC had exclusive jurisdiction over such products, the CFTC's less stringent regulatory requirements might cause the underlying stocks to be susceptible to manipulation through trading of the overlying futures.

Among the regulatory disparities between futures and equities or equity options are the CEA's absence of comparable insider trading provisions, weaker frontrunning and disclosure rules, and lack of private rights of action. In addition, a major area of concern relates to the margin requirement for futures. Historically, the futures markets have applied lower margin requirements to futures than that applied by securities markets to equities. Accordingly, futures could provide a way for investors to obtain access to an underlying security on substantially lower margin. Because of the linkages between futures and securities markets, this could have a disruptive effect on the trading of individual stocks.

Institutional OTC Markets. Proponents of an exemption for swaps and other privately negotiated OTC derivative transactions argue that an exemption from the CEA would provide legal certainty for participants in this market. CFTC rules already exempt certain swaps from regulation under the CEA.⁸ These rules were adopted in 1993 pursuant to exemptive authority granted to the CFTC under the Futures Trading Practices Act of 1992.⁹ Although most market participants did not consider swaps to be futures under the CEA,¹⁰ these exemptive

⁸ 17 C.F.R. Part 35.

⁹ P.L. No. 102-546; 106 Stat. 3590 (1992).

¹⁰ The views of market participants were based, in part, on guidance provided by the CFTC. In 1989, the CFTC issued a policy statement concerning swap transactions in which it expressed the view that "most swap transactions, although possessing elements of futures or options contracts, are not appropriately regulated as such under the [CEA] and regulations." 54 FR 30694 (Jul. 21, 1989). The CFTC provided additional
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rules provided some assurance that a private litigant would not claim that a swap was an illegal future. The CFTC's exemptive authority did not extend to securities products, however, because of concerns that it could be used to eradicate the Shad-Johnson Accord. As a result, some market participants believe that legal uncertainty continues to impair the development of equity swaps due to the risk that equity swaps would be deemed futures on single stocks in violation of the Shad-Johnson Accord.

The Commission agrees that it is important to provide the market with legal certainty for privately negotiated, OTC swaps and other derivative transactions effected between large institutional counterparties. The market in these transactions, in contrast to the exchange market described above, has developed outside of the scope of CFTC regulation and does not contribute to any great extent in the price discovery or liquidity functions performed by regulated exchange markets. While the Commission appreciates the desire of market participants to ensure that securities-based swaps do not fall within the CEA, the Commission is concerned by any efforts to provide legal certainty through an exemptive approach. First, a broad exemptive approach would provide privately negotiated, OTC transactions between institutional counterparties with an exemption from all provisions of the CEA, including the Shad-Johnson Accord. The SEC is concerned that this could lead to pressure for additional exemptions from Shad-Johnson for

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guidance to OTC derivatives traders when it adopted its Part 35 rules in 1993. In the release adopting the rules, the CFTC stated that the issuance of the rule should not be construed as reflecting any determination that the swap agreements covered are subject to the CEA, "as the Commission has not made and is not obligated to make any such determination." 58 FR 5588 (Jan. 14, 1993).

exchange-traded futures,¹¹ in retail as well as professional market transactions, and that it would impair the Commission's antifraud authority over transactions in OTC derivatives that would otherwise be deemed securities.

Second, an exemptive approach could allow some market participants to argue that because swaps are *exempted* from the CEA, they were presumed to be futures in the first place. Otherwise, no *exemption* would have been needed. Based on this presumption, the courts could determine that, because the CFTC has exclusive jurisdiction over futures, *exempted* swap products would be free from oversight by other federal regulators. Such a determination would be further supported by the fact that swaps would remain subject to the antifraud and antimanipulation provisions of the CEA.

A better approach would be to *exclude* from the CEA privately negotiated, institutional OTC transactions in securities-based swaps. This approach would preserve the interest of the Commission in securities-based products while providing the legal certainty that the products would not be deemed illegal futures. Such an approach also would not open the Shad-Johnson Accord to renegotiation by the SEC, CFTC, and their Congressional oversight committees. This is the approach currently used to exclude transactions in government securities and foreign currency from the CEA by means of the Treasury Amendment. Moreover, this approach would continue to uphold the Shad-Johnson ban against futures on individual securities, as well as the SEC's consultative role regarding index futures,¹² while ensuring that the CEA would not be

¹¹ See Consolidated Testimony of the Futures Exchanges of the United States before the Committee on Agriculture, Nutrition and Forestry, United States Senate (Feb. 11, 1997).

¹² In connection with the SEC's consultative role regarding index futures, we understand (continued...)

applied to privately negotiated, institutional OTC transactions.

Treasury Amendment. The Commission agrees that the scope of the Treasury Amendment to the CEA needs to be clarified. The Treasury Amendment currently excludes from the CEA certain OTC transactions in foreign currency, government securities, securities warrants, securities rights, resales of installment loan contracts, repurchase options, mortgages, and mortgage purchase agreements. The Treasury Department requested this amendment to the CEA in 1974, primarily to avoid overly burdensome regulation of the OTC foreign exchange and government securities markets. There has been a dispute for several years, however, regarding whether OTC options and futures on the enumerated instruments fall under the Treasury Amendment exemption from the CEA.¹³

Section 201 of the bill would grant the CFTC jurisdiction over transactions involving futures and options¹⁴ on Treasury Amendment instruments that are sold to the general public

¹²(...continued)

that the current requirements and procedures of the Shad-Johnson Accord would continue to apply under the bill. Nevertheless, we believe it is important that the bill clarify that the requirements and procedures outlined in the Shad-Johnson Accord would apply not only to the proposed provisions governing the submission and disapproval of contract market rules in Section 104 of the bill, but also would require that no board of trade designated as a contract market under Section 103 of the bill be permitted to trade index futures until the appropriate requirements and procedures in the Shad-Johnson Accord are satisfied.

¹³ The Supreme Court recently addressed the interpretation of the Treasury Amendment in Dunn v. CFTC, holding that the CFTC does not have authority under the Treasury Amendment to regulate off-exchange trading in foreign currency options. In reaching its conclusion, the Court relied on issues of statutory construction. The Court also recognized that the case raised significant public policy considerations that would be best addressed by the Congress. 1997 WL 75492 (Feb. 25, 1997).

¹⁴ While Section 201 of the bill does not expressly grant the CFTC jurisdiction over retail options transactions conducted on a board of trade, the proposed addition to the Treasury
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on a board of trade.¹⁵ This appears to include options on government securities and other securities products listed in the Treasury Amendment, which are regulated under the federal securities laws. While the Commission shares the concern over bucket shops that market foreign currency futures and options to retail investors, for other Treasury Amendment products, the bill should limit the CFTC's jurisdiction to exchange-traded futures and options on futures and clarify that options on securities (or groups or indices of securities) are specifically excluded from regulation under the CEA consistent with the provisions of the Shad-Johnson Accord.

In considering how best to address issues raised by the Treasury Amendment, the Commission supports the proposal to amend the CEA submitted by the Treasury Department, with some modifications. Treasury's proposal reflects the principle that the appropriate legal standard should adequately protect retail investors while promoting legal certainty for off-exchange, institutional derivatives transactions. In this regard, Treasury's proposal would limit CFTC jurisdiction over OTC derivatives involving Treasury Amendment instruments to foreign currency derivative transactions between retail customers and unregulated persons.¹⁶ While

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Amendment of the phrase "or transactions involving [the enumerated instruments]" appears to be intended to encompass options transactions.

¹⁵ The bill does not define "general public." Consequently, it is not clear whether the purpose of Section 201 is to provide an exclusion from the CEA for institutional OTC transactions involving futures and options on enumerated instruments, or whether the exclusion is intended to be broader and support the establishment of an unregulated futures exchange market. As noted earlier, the Commission opposes the proposed professional market exemption contained in the bill.

¹⁶ A "retail customer" is defined to include any natural person other than a natural person with a net worth above \$1 million or with an annual income of more than \$200,000 (or \$300,000 when combined with one's spouse). The term "unregulated person" generally is defined as a person who is not currently regulated by one of the federal bank regulators or is not a broker-dealer or investment company regulated by the SEC.

Treasury's approach clarifies CFTC jurisdiction over foreign currency bucket shops and boiler rooms, the Commission believes that it is not appropriate to limit that antifraud protection only to natural persons having assets under \$1 million, but instead would recommend that the standard be increased to \$10 million.

Treasury's proposal would also grant the CFTC full regulatory jurisdiction over options and futures traded on an "organized exchange" (except options on securities or those otherwise subject to SEC jurisdiction). It would not, however, grant the CFTC any additional jurisdiction over derivatives transactions involving other Treasury Amendment instruments that are not traded on an "organized exchange." While the Commission supports provisions that would give the CFTC jurisdiction only over exchange-traded products, and not over OTC derivatives involving Treasury Amendment instruments (other than retail foreign currency derivatives), the definition of "organized exchange" should be clarified so as not to accommodate the establishment of an unregulated professional exchange market.¹⁷

The Commission appreciates the opportunity to offer its perspectives on the proposed amendments to the CEA contained in H.R. 467, and supports efforts to assist government in responding to changing market conditions. It is important, however, that any amendments to the CEA preserve the efficiency of the cash markets while allowing for the development of effective derivative markets, including OTC markets. The Commission and its staff welcomes any questions on these issues that the Subcommittee may have, and looks forward to continued

¹⁷ In addition, as discussed above in the text, the Commission supports the exclusion from the CEA of certain additional privately negotiated, OTC transactions in securities derivatives involving institutional counterparties. This could be accomplished by broadening the scope of the Treasury Amendment.

discussions with the Subcommittee, the President's Working Group on Financial Markets, interested agencies, and industry groups on these important issues.