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

March 15, 1991

The Honorable Donald W. Riegle, Jr.
Chairman
Committee on Banking, Housing and Urban Affairs
United States Senate
Washington, D.C. 20510

Dear Chairman Riegle:

Last week the Senate Agriculture Committee marked up S. 207, the "Futures Trading Practices Act of 1991". The provisions of Title III of S. 207, entitled "Intermarket Coordination", are highly restrictive and seek fundamentally to restrain competition. Title III of S. 207 also contains provisions that would alter the basic jurisdiction of the Securities and Exchange Commission ("SEC") as it has existed, in large part, since enactment of the Securities Act of 1933 and the Securities Exchange Act of 1934. This letter presents my views on the effect that Title III would have, if enacted, on the jurisdiction of the SEC and, more broadly, on the competitiveness of U.S. securities markets.

The impact of this legislation would diminish the vitality and competitiveness of U.S. securities markets internationally. It would also weaken their ability to facilitate the raising of capital for U.S. businesses at the lowest possible cost. As a result of this codification of the most expansive possible interpretation of the commodities laws, most new innovative hybrid securities products, as well as an unknown number of banking products and swaps transactions would, in effect, become illegal if traded or sold anywhere other than on a futures exchange unless licensed or approved by the Commodities Futures Trading Commission ("CFTC"). New products would be barred from heretofore open and competitive markets unless market participants engaged in lengthy and expensive regulatory proceedings to prove to the CFTC that these products should be allowed to exist.

<u>Purposes and Effects of Title III on SEC Jurisdiction</u>

Under the language of sections 302, 303 and 304 of S. 207 as marked up, for the first time in history, trading in securities on the nation's securities exchanges would depend, by statute, on the affirmative action of an agency other than the SEC. For this reason, these provisions of S. 207 represent a fundamental and highly significant change to the nation's securities laws.

If enacted, this legislation could be read to transfer one of the SEC's most important and fundamental responsibilities, that of defining "securities," to the CFTC. As a result, the jurisdiction of the SEC would be permanently reduced, to the detriment of the SEC's ability to apply a coherent system of securities laws to future developments in the nation's capital markets.

S. 207 would also appear designed to transfer jurisdiction over index options products currently listed on the Chicago Board Options Exchange, American Stock Exchange, New York Stock Exchange, Philadelphia Stock Exchange and Pacific Stock Exchange (and perhaps even options on individual securities) to the CFTC. New section 4c(g)(B) of the Commodity Exchange Act ("CEA"), added by Section 303 of S. 207, specifies that any transaction "in or involving a commodity regulated under this Act ... shall be subject to regulation by the [CFTC]." Since stock indexes are treated as commodities for purposes of the agricultural laws, this provision appears designed to transfer regulation of the index options markets from the SEC to the CFTC. Trading in such index options last year exceeded $2.5 <u>trillion</u>, making them the largest derivative markets for U.S. equity securities. Oversight of the nation's options trading markets has been the exclusive function of the SEC since 1934.

Title III also subjects the very large and highly competitive swaps market, in which major U.S. banks and securities firms are principal participants along with U.S. corporations, to the agricultural laws of the United States under the jurisdiction of the Agriculture Committee. Similarly, S. 207 provides for exemptions from the CEA for many, though perhaps not all, "demand deposits, time deposits, or transaction accounts" within the meaning of the federal banking laws. By stipulating the conditions under which an exemption from the exclusivity clause of the CEA may be provided, S. 207 appears designed to create the impression that jurisdiction over these banking and securities products has been transferred, at least in part, to the CFTC.

Many provisions of Title III of S. 207 appear to have been drafted just before markup, without ever being the subject of hearings and without the participation of the SEC. The effects of these provisions, which would represent a very significant transfer of jurisdiction, may simply be the unintended consequences of hasty and ill-considered drafting. Nevertheless, they may do enormous damage to the securities, options and swap markets, which compete with futures exchanges, if the process moves too rapidly for thorough study of the effects of Title III.

<u>Title III Is Not a "Compromise"</u>

As you know, last year Senators Dodd, Heinz and Bond of the Banking Committee reached a compromise with Senators Leahy and Lugar of the Agriculture Committee. The compromise concerned, among other things, the reforms necessary to curtail the flagrantly anticompetitive "exclusivity clause" of the CEA.

The staff of the SEC worked together with the staff of the Senate Banking and Agriculture Committees for literally hundreds of hours to perfect the necessary legislative language to implement this compromise. This language was formerly included in Title III of S. 207. The SEC testified in favor of this draft language in a hearing held before the Agriculture Committee on February 7, 1991.

At some point between the hearing on February 7 and the markup by the Agriculture Committee last week, the carefully developed compromise language of Title III was replaced completely by the current language of Title III of S. 207, which we understand was still being written during the night before markup. The SEC never testified concerning the new “midnight language”, and we did not receive a copy of it until completion of the markup. Indeed, to my knowledge no hearing has ever been held in any committee of either the Senate or the House of Representatives to consider the impact of this language on the nation’s securities, banking, swaps and other financial markets. Instead, apparently the future development of the American capital markets is to be governed by the agricultural laws of the United States without consideration whatever of the effect that this change may create.

Title III of S. 207 now represents no compromise at all. Rather, Title III will be read as codifying the most expansive imaginable application of the exclusivity clause. Ideally, those who have promoted the new language can come forward in the open and provide explanations for why it represents sound public policy. After public consideration of the impact of this legislation, Congress would be in a better position to determine whether to continue to allow the agricultural laws to be used to drive innovative new financial products out of the capital markets of the United States.

Problems with Title II

Moreover, Title II of S. 207, for the first time in history, would grant the CFTC jurisdiction over broker-dealers registered with the SEC under the Securities Exchange Act of 1934 where any such firm is affiliated with a futures commission merchant (“FCM”). Section 272 of Title II of S. 207 contains provisions designed to create holding company oversight over the affiliates of FCMs in a manner very similar to the authority granted to the SEC by Congress last year as part of the Market Reform Act initiated by the Committee on Banking, Housing and Urban Affairs. In the absence of any provisions that the rules and requirements of the CFTC applicable to the broker-dealer affiliates of FCMs would be conformed to the pre-existing reporting obligations of broker-dealers to the SEC, enactment of Title II would impose substantial additional regulatory costs on securities firms.

The additional and possibly very substantial new regulatory costs that Title II would impose on securities firms would come at a time when earnings are under very great pressure, and when more than 60,000 jobs have been eliminated in the industry as a whole. Given that FCM subsidiaries of broker-dealer holding companies are typically trivial in size compared with their broker-dealer affiliates, and that holding company oversight already exists for such firms, it is not clear why broker-dealers or their holding company affiliates within the jurisdiction of the SEC should be subjected to such unnecessary regulatory controls and related expenses.

Conclusion

In the view of the SEC, it is bad public policy to severely restrict the flexibility of banks and securities firms to design new instruments to serve the financial needs of businesses across the United States as would occur under the provisions of S. 207. I personally believe that the needs of our markets should not be sacrificed to domestic protectionism for any group. Ideally, we should seek to strip away anticompetitive laws like the exclusivity clause, not strengthen and extend them.

At a minimum, however, any decision to so dramatically narrow the traditional functions of the SEC and the flexibility of our securities markets should only be made after public hearings and full consideration by the Committees with responsibility for the financial laws and markets of the United States. Indeed, this legislation would appear to render the reauthorization of the SEC later this year much less meaningful. Whatever you and the Committee can do to restore fairness and order to the legislative process with regard to these proposals so important to the securities laws and markets will be most appreciated.

Sincerely,

Richard C. Breeden
Chairman