MEMORANDUM

November 17, 1977

TO: The Commission

FROM: Office of the General Counsel

RE: Request from the General Accounting Office for the Commission's views "whether the Commodity Exchange Act should be amended to have the Securities and Exchange Commission assume the responsibilities of the present CFTC."

RECOMMENDATION: That the Commission consider the matter and authorize the Office of the General Counsel to communicate the Commission's views to the GAO.

NOVEL, UNIQUE OR COMPLEX ISSUES: Request for comments in connection with the Congressional consideration whether to reauthorize the CFTC pursuant to the provision in the Commodity Futures Trading Commission Act of 1974 which authorizes appropriations for the CFTC only through the fiscal year ending September 1978, as if the CFTC were subject to a statutory "sunset" provision.

OTHER OFFICES AND DIVISIONS CONSULTED: Comments were requested from the Executive Director, the Divisions of Corporation Finance, Corporate Regulation, Enforcement, Investment Management and Market Regulation, the Office of the Chief Accountant and the Directorate of Economic and Policy Research. Copies of the written comments received are attached.

ACTION REQUESTED BY: As soon as possible

SUNSHINE ACT STATUS: Closed

By letter dated August 9, 1977 (Attachment 1), the Director of the General Accounting Office's Division of Financial and General Management Studies solicited the Commission's views "whether the Commodity Exchange Act should be amended to have the Securities and Exchange Commission assume the responsibilities of the present CFTC." The request is made in the context of a study by the GAO of the operations of the CFTC, initiated in part by a request from the Senate Committee on Agriculture, Nutrition and Forestry.

As indicated in the GAO letter, one of the Senate Committee's concerns is whether the CFTC should be reauthorized for the period after the fiscal year 1978. 1/

The attached comments from the various Commission staff offices and divisions reflect disagreement on the advisability of such a merger, with several divisions indicating that certain administrative and regulatory efficiencies would likely result, while others note that the industries involved are in many respects fundamentally different. 2/

I. Areas of Similarity and Differences

The futures market system that has evolved since the end of the 19th century has numerous parallels with the securities markets. Thus, futures contracts are traded at auction on exchanges ("contract markets"), as profit making vehicles, with a system of brokers ("futures commission merchants") and traders. Problems relating to clearing systems, the safety of customer funds, and the financial condition of brokers are similar within the two systems. Moreover, certain other regulatory problems are at least partially comparable in the futures and securities markets, e.g., market manipulations and customer suitability.

The CFTC's responsibilities as the regulator of the commodity futures markets are, to some extent, similar to the Commission's responsibilities over securities markets. The CFTC is charged with prevention of manipulation in the futures markets (Sections 4b and 4c of the Commodity Exchange Act ("CEA" 3/)) and with registration and regulation of exchanges ("contract markets") and futures commission merchants (see, e.g., Sections 4, 4d, 4g, 4h,

---

1/ In a recent speech, Michael R. McLeod, the staff director of the Senate Committee on Agriculture, Nutrition and Forestry stated that the Committee is using the appropriation process to conduct a "full Sunset review" of the agency. (BNA Securities Regulation and Law Report, September 28, 1977, at A-7-A-8). Among the possibilities mentioned, in addition to reauthorization of the CFTC as presently constituted or as a single-headed agency, are return of its functions to the Department of Agriculture under a single administrator, transfer to the Department of the Treasury under a single administrator, or to this Commission. The report of Mr. McLeod's speech also indicated the existence of some strong Congressional dissatisfaction with the CFTC's performance and management.

See also the recent series on the CFTC in the "Business and Finance" section of the Washington Post, October 24-28, 1977.

2/ The Division of Enforcement advised us orally that it thought it would be inappropriate for the Commission to comment on a sister agency in this situtation.

3/ 7 U.S.C. 1, et seq. The CEA was substantially revised by the Commodity Futures Trading Commission Act of 1974 ("CFTCA"), which created the CFTC.

and 4p of the CEA). 4/ The nature of the regulation of commodity futures commission merchants is similar to the regulation of securities broker-dealers, e.g., net capital requirements and customer suitability. The CFTC is also charged with responsibility for considering major changes in the futures markets similar to responsibilities imposed on this Commission in 1975. See Section 4j, CEA (determination whether floor traders and futures commission merchants may trade for their own accounts while also executing customers' orders); 5/ Section 17 (enabling authority for registration of national futures associations); Section 18 (directive to establish research and information programs to determine, inter alia, the feasibility of trading by computer).

When, however, the futures and securities markets are viewed from the perspective of the instruments subject to regulation and their economic function, marked differences become apparent. The function of traditional futures contracts, and the nature of the cash commodities to which they relate, make them radically different from securities.

The futures markets do not have a capital raising function similar to the securities markets. They are intended to be commercial, not investment, markets; and, when they operate as originally envisioned, it cannot be said, in the usual securities sense, that the purchase of a futures contract is an investment "in" anything. In that context, a futures contract is not an ownership interest in an enterprise, as is an equity security; rather, it is a right, which terminates within months, to receive the cash value of market fluctuations, or to demand or make delivery of specified goods. One of the primary purposes of the futures markets is to provide a mechanism — by the purchase of futures contracts — for commercial interests to hedge inventories or requirements in cash commodities; 6/ and members of the public who participate

---

4/ The CFTC also has regulatory authority over "commodity pool operators" and "commodity trading advisors" (Sections 4m through 4o, CEA), similar to the Commission's authority over investment companies and investment advisers. Section 417 of the CFTCA of 1974 also required the CFTC to report to Congress on the feasibility of establishing an insurance program similar to SIPC. See note, 7 U.S.C. 4a.

5/ The CFTC decided in December 1976 to permit such trading, but under limited circumstances. See 17 C.F.R. 155.1, et seq. and 41 F.R. 56134 (December 23, 1976).

6/ See Section 3 of the CEA, which is the section describing the public interest in regulation of futures transactions: "[S]uch transactions are carried on in large volume by the public generally and by persons engaged in the business of buying and selling commodities and the products and byproducts thereof in interstate commerce; * * * the prices involved in such transactions are generally quoted and disseminated throughout the United States and in foreign countries as a basis for determining the prices to the producer and the consumer of commodities and the products and byproducts thereof and to facilitate the movements thereof in interstate commerce; * * * such transactions are utilized by shippers, dealers, millers and others engaged in handling commodities * * * as a means of hedging themselves against possible loss through fluctuations in price."

in the futures markets are, by definition, "speculators," because they are not members of the commodities industry engaged in hedging operations. See "Glossary of Terms," excerpted from S. Rep. No. 93-1131, 93rd Cong., 2d Sess. 101-104 (1974), and reprinted at 134-137 in the November 15, 1974, Senate Agriculture Committee print of selected materials relating to the CFTCA. The speculator's function is to provide the "liquidity necessary to create an effective hedging mechanism" (CBOT, Commodity Trading Manual (1973), p. 103); he assumes the "risks of price fluctuation," "for the sake of profit." Id.

Accordingly, while there are similarities between the two market structures, the regulatory goals of securities and futures legislation are different. This is suggested by the following statement of Representative Poage, Chairman of the House Agriculture Committee (119 Cong. Rec. H 41335 (1973)):

> "There was also a proposal advanced briefly to place the regulation of futures trading within the present SEC. The advantages were the existence of the SEC as an independent regulatory structure. The disadvantages were legend.
>
> "Often erroneously viewed as twins, there is little correlation in theory or in fact between the regulation of futures trading and the regulation of securities transactions. Futures trading regulation is essentially a regulation of a marketing device, that is, a contract right which is terminable at a time certain, for agricultural commodities while the SEC regulates the handling of certificates of tangible ownership which are permanent in nature."

Commodities legislation stresses the economic role of futures markets as pricing mechanisms rather than as capital markets, 7/ and the CEA requires that many regulatory decisions take cash market concerns into account. See Section 4a(1) (fixing of position limits to diminish distortion of cash commodity prices); Section 4c(a) (prohibition of certain manipulative transactions which affect the price of cash commodities); Section 5(a) (requiring, inter alia, that before a contract market may be designated by the CFTC, the market must be "located at a terminal market where any cash commodity of the kind specified in the [futures] contracts * * * is sold in sufficient volumes and under such conditions as fairly to reflect the general value of the commodity * * *"); Sections 5a(3), (4), (5), (6), (7), (8) (self-regulation by contract markets, subject to CFTC review and disapproval proceedings, of warehouse arrangements, grades of cash commodity, and methods of delivery of the cash commodity).

7/ As the Senate Committee on Agriculture and Forestry noted: "Properly operating futures markets help to hold down consumer prices by reducing middleman costs. However, improperly operating futures markets can have the opposite result." S. Rep. No. 93-1131, 93rd Cong., 2d Sess. (Aug. 29, 1974), p. 18.

The similarity between securities options and commodities futures, noted by the Directorate of Economic and Policy Research, should not be overemphasized as a basis for concluding that, since this Commission regulates trading in securities options, it should also regulate all of the commodities futures markets, including those involving agricultural commodities. Securities options markets are ancillary to the capital markets. And the Commission's regulation of the options markets differs somewhat from its traditional concern for disclosure regarding the financial condition of the enterprise in which an investment is made. 8/

In sum, a primary focus of futures regulation, in contrast to the disclosure orientation of the securities laws, is regulation of the markets to prevent economic distortion in the underlying commodities. As the Division of Market Regulation states:

> "Commodity futures trading * * * is the tip of an iceberg whose submerged portion usually represents more than 90 percent of the commerce in the underlying commodities and includes supply and requirements arrangements, international trade agreements, and other aspects of the production, processing and consumption of those commodities."

Accordingly, while the two market systems may be viewed as structurally comparable, and thus susceptible to combined regulation, they are also different, both econcomically and substantively.

On the other hand, the Commission cannot ignore the fact that the same persons who invest in securities or in stock options are being solicited to purchase, instead, commodity futures contracts. And, at times, it is difficult to distinguish between a security and a futures contract. 9/ Moreover, although originally viewed as a device to hedge against underlying commodities, recent proposals for new futures contracts are suddenly taking the direction of securities. 10/ While the economic criteria applicable to CFTC approvals of new futures contracts presumably should preclude at least some of these developments, 11/ that agency has shown an unfortunate

---

8/ The disclosure document required in the sale of securities options does not require detailed disclosure regarding the underlying security.

9/ See Bache Halsey Stuart, Inc. v. Affiliated Mortgage Investments, Inc., N.D. Ga., Civil Action No. C76-272A.

10/ For example, the Kansas City Board of Trade has filed with the CFTC a proposal to trade futures contracts in the Dow Jones industrial average. See article in the Washington Post, Nov. 3, 1977 (Attachment 3).

11/ The proposal to trade futures contracts in the Dow Jones industrial average could not, in our view, meet the requirements of the CFTCA. Nevertheless, while no definitive position on the issue has been reached, we are advised that the CFTC likely will approve the plan. The article in the Washington Post (Attachment 3) notes that, when a similar contract was proposed by the Chicago Board of Trade prior to the creation of the CFTC, the Commission rejected the proposal.

tendency to concern itself more with expanding its jurisdiction than fulfilling its Congressional mandate (see page 8, infra).

II. Effects on the Operation of the Commission and on Regulated Entities

The foregoing comparison of commodities and securities regulation suggests several administrative and regulatory consequences of a merger. Thus, the enforcement expertise appropriate to regulation of market manipulation in the futures and securities markets would be easily transferable between the two agencies.

Moreover, certain of the duties of the market regulation staffs of the agencies appear to be comparable. As noted by the Division of Market Regulation, the regulated brokers are often the same firms in the securities and commodities fields, and customer protection goals seem to be parallel. 12/ Under the circumstances, benefits surely would accrue to firms like Merrill Lynch from elimination of a second regulatory agency overseeing its functions.

In addition, the 1974 amendments to the CEA adopted the concept of a self-regulatory organization similar to the NASD, distinct from the separate boards of trade, and authorized registration of a "futures association" (Section 17, CEA). The fact that the NASD might be able to assume these functions, as suggested by the Directorate of Economic and Policy Research, might promote significant simplification of regulation.

However, these administrative and regulatory efficiencies and others, such as reduction in total agency overhead, should be balanced by consideration of the changes that would probably be necessary for this Commission to adapt to the increased responsibilities that would be imposed by assumption of commodity futures regulation.

While we do not suggest that increased staff size (estimated by the Executive Director to be 25 per cent) would by unmanageable, it seems apparent that increased workload would be manageable only by a substantial increase in delegation of the Commission's authority and changes in the nature of the individual Commissioner's duties. These changes would likely include more quasi-judicial activities, much more purely regulatory concerns, whether in the area of review of exchange rules or promulgation of the Commission's own rules, and would likely result in a reduction in the amount of time available for Commissioners to spend on, for instance, enforcement activities, while the agency's enforcement activities and litigation would necessarily increase.

Such changes might alter this Commission's traditional character. In this regard, the legislative history of the Securities Exchange Act indicates that the creation of this Commission in 1934, and the transfer

---

12/ Similarly, the expertise of the Commission's Division of Investment Management should be applicable to regulation of commodity pool operators and commodity trading advisors.

to it from the Federal Trade Commission of the responsibility for administration of the Securities Act, occurred because it was felt that the regulatory responsibilities under the securities laws required separate, expert and independent administration by a body which could act quickly, not distracted by the demands of the FTC's existing responsibilities. See Letter from the President to the Chairman of the Committee on Banking and Currency, January 25, 1934, with Report of Commerce Department Study Group attached, Senate Banking and Currency Committee Print, 73d Cong., 2d Sess. (1934), p. 7.

A similar argument in opposition to a transfer of the CFTC to this Commission would seem equally applicable, particularly since regulation of commodities also contemplates the necessity for emergency actions. See Section 8a(9), CEA:

> "[The CFTC is authorized] to direct the contract market whenever it has reason to believe that an emergency exists, to take such action as, in the Commission's judgment, is necessary to maintain or restore orderly trading in, or liquidation of, any futures contract. The term 'emergency' as used herein shall mean, in addition to threatened or actual market manipulations and corners, any act of the United States or a foreign government affecting a commodity or any other major market disturbance which prevents the market from accurately reflecting the forces of supply and demand for such commodity* * *."

A variation on this argument was advanced by Representative Poage in 1973 in connection with consideration of the creation of the CFTC:

> "The existence of another, more volatile regulatory function with the SEC could create difficulties that could probably never be overcome. No SEC Commissioner is appointed because of expertise in futures trading, and a merger of the staffs of the CEA within the respective organizations would do little more than precipitate a continuing conflict as to the priorities of the Commission with its jurisdiction so confused."

119 Cong. Rec. H 41335 (1973).

III. Jurisdictional Conflicts Between this Commission and the CFTC

As the Commission is aware, there has been disagreement between this Commission and the CFTC over the proper scope of the statutory grant of exclusive jurisdiction to the CFTC. 13/ The CFTC, taking the position that

---

13/ Section 2(a)(1) of the CEA, as amended in 1974 by the CFTCA, provides, in relevant part, that the CFTC

> "shall have exclusive jurisdiction with respect to accounts, agreements (including any transaction which is of the character

(continued)

its grant of exclusive jurisdiction is to be broadly construed, 14/ has, we believe, been more concerned with expanding its area of exclusive jurisdiction, and thus narrowing the authority of this Commission and of state agencies, than with the need to assure adequate protection of the public. 15/

A merger of the CFTC into this Commission would, of course, eliminate the unseemly situation of these two government agencies engaging in a dispute over their respective jurisdictions. It might not, however, eliminate the necessity to interpret the scope of the exclusive jurisdiction provision, since that provision may do more than merely delineate the respective jurisdictions

---

13/ (Footnote continued)

> of, or is commonly known to the trade as, an 'option', 'privilege', 'indemnity', 'bid', 'offer', 'put', 'call', 'advance guarantee', or 'decline guaranty'), and transactions involving contracts of sale of a commodity for future delivery, traded or executed on a contract market designated pursuant to section 5 of this Act or any other board of trade * * *."

14/ See the Supplemental Memorandum of the Commodity Futures Trading Commission, Amicus Curiae, filed in Securities and Exchange Commission v. Univest, Inc., C.A. 7, No. 76-1734.

15/ The CFTC has appeared in federal and state courts, asserting that the Securities and Exchange Commission and state securities agencies no longer may take action under securities statutes with respect to the offering of investment contracts involving options on commodities - futures. See, e.g., the CFTC's amicus curiae briefs in Securities and Exchange Commission v. Univest, supra, and in Securities and Exchange Commission v. American Commodity Exchange, Inc., C.A. 10, No. 76-1064. In its brief in the latter case, the CFTC, although acknowledging that this Commission may obtain, at the present time, injunctive relief for commodities-related violations of the securities laws if the violations occurred prior to the effective date of the CFTC Act, went on to suggest, nevertheless, that it perhaps should be difficult for district courts to grant such relief at this time.

of different agencies. It also may govern whether particular activities involving commodity futures are subject to regulation exclusively under the commodities laws or also under the securities laws. 16/

JHStillman - 51144
GMays - 51279

Attachments: 1. August 9, 1977, letter from General Accounting Office

2. Comments: a. Economic and Policy Research; b. Executive Director; c. Market Regulation; d. Corporation Finance; e. Investment Management

3. November 3, 1977, article in the Washington Post

16/ At a minimum, therefore, we believe that the Commission should, in its response to the GAO's inquiry, urge that Congress enact legislation eliminating the grant of exclusive jurisdiction to the CFTC, and substituting in its stead provisions comparable to those added to the Securities Exchange Act in 1975, requiring prior consultation and coordination between the Commission and the banking agencies in certain specified circumstances. See Sections 15B(c)(6)(A), 17(b) and 17A(d)(3)(A) of the Securities Exchange Act.