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CHAIRMAN'S OFFICE
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Signed by: _____

Honorable Daniel Glickman
House of Representatives
Washington, D.C. 20515

Dear Congressman Glickman:

After my testimony on Tuesday, February 22, 1978, before the Subcommittee on Conservation and Credit, you requested that the Commission submit a proposed amendment to the Commodity Exchange Act, which would clearly establish the Commission's jurisdiction over futures on securities, and relieve the Commodity Future Trading Commission of its present obligations with respect to such futures.

In response to your request, our General Counsel's Office has drafted the enclosed proposed amendment to the Commodity Exchange Act. In addition, I am enclosing, for your consideration, a prepared justification for, and analysis of, this draft legislation. We have also prepared a redraft of Section 2 of the Commodity Exchange Act to show the effect of our proposed amendments.

I hope that these materials will be useful to you. If we can be of any more assistance to you, you may want to have members of your staff contact Robert Pozen, Assistant General Counsel to the Commission, at 755-1224.

Sincerely,

Harold M. Williams
Chairman

Enclosures

HMW:cj

Glickman

LEGISLATIVE PROPOSAL SUBMITTED, UPON REQUEST
TO CONGRESSMAN DANIEL GLICKMAN OF THE HOUSE
OF REPRESENTATIVES COMMITTEE ON AGRICULTURE

A BILL

To amend the Commodity Exchange Act (7 U.S.C. §1) to provide an appropriate division of responsibilities between the Securities and Exchange Commission and the Commodities Futures Trading Commission with respect to future contracts on securities.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, that

Sec. 2. Section 2 of the Commodity Exchange Act (7 U.S.C. §2) is amended as follows:

- (a) by inserting immediately after the phrase "interests in which contracts for future delivery are presently or in the future dealt in," the following: "but shall not include any 'security' within the meaning of Section 2(1) of the Securities Act of 1933";
- (b) by deleting the phrase", except as hereinabove provided," appearing immediately after the phrase" And provided further, That"; and
- (c) by deleting the word "thereof" appearing immediately after the phrase "unless such transactions involve the sale", and inserting in lieu thereof "of a commodity (as hereinabove defined)".

If Congress were to make the three changes suggested by the Securities and Exchange Commission in Section 2 of the Commodity Exchange Act, 7 U.S.C.

§2, the Section would then read as follows (the added words are underlined and the deleted words are crossed out):

For the purposes of this chapter "contract of sale" shall be held to include sales, agreements of sale, and agreements to sell. The word "person" shall be construed to import the plural or singular, and shall include individuals, associations, partnerships, corporations, and trusts. The word "commodity" shall mean wheat, cotton, rice, corn, oats, barley, rye, flaxseed, grain sorghums, mill feeds butter, eggs, Solanum tuberosum (Irish potatoes), wool, wool tops, fats and oils (including lard, tallow, cottonseed oil, peanut oil, soybean oil and all other fats and oils), cottonseed meal, cottonseed, peanuts, soybeans, soybean meal, livestock, livestock products and frozen concentrated orange juice, and all other goods and articles, except onions as provided in Section 13-1 of this title, and all services, rights, and interests in which contracts for future delivery are presently or in the future dealt in, but shall not include any "security" within the meaning of Section 2(1) of the Securities Act: Provided that the Commission shall have exclusive jurisdiction with respect to accounts, agreements (including any transaction which is of the character of, or is commonly known to the trade as, an "option", "privilege", "indemnity", "bid", "offer", "put", "call", "advance guaranty", or "decline guaranty"), and transaction involving contracts of sale of a commodity for future delivery, traded or executed on a contract market designated pursuant to Section 7 of this title or any other board of trade, exchange, or market, and transactions subject to regulation by the Commission pursuant to section 15a of this title: And provided further, ~~That/ except as hereinafore provided/~~ nothing contained in this section shall (i) supersede or limit the jurisdiction at any time conferred on the Securities and Exchange Commission or other regulatory authorities under the laws of the United States or of any State, or (ii) restrict the Securities and Exchange Commission and such other authorities from carrying out their duties and responsibilities in accordance with such laws. Nothing in this section shall supersede or limit the jurisdiction conferred on courts of the United States or any State. Nothing in this chapter shall be deemed to govern or in any way be applicable to transactions in foreign currency, security warrants, security rights, resales of installment loan contracts, repurchase options, government securities, or mortgages and mortgage purchase commitments, unless such transactions involve the sale ~~thereof/~~ of a commodity (as hereinabove defined) for future delivery conducted on a board of trade.

* * *

Justification for the Proposed Amendments

The proposed amendments to Section 2 of the Commodity Exchange Act are intended to provide the Securities and Exchange Commission (the "Commission") with regulatory and enforcement authority over futures on all securities. These amendments are necessary to protect the existing jurisdiction of the Commission over securities and securities options, because of the close connections among the market for securities, the market for securities options, and the market for futures on these same securities.

When Congress enacted the Commodity Futures Trading Act in 1974, it recognized the compelling need for a comprehensive regulatory scheme over the commodity futures industry in this Country. Cognizant that the futures industry was expanding beyond the traditional futures contracts on agricultural products, Congress determined to vest some jurisdiction over these futures contracts on financial instruments in the Commodity Futures Trading Commission (the "CFTC"). Thus, Congress amended the definition of the term "commodity" in the Commodity Exchange Act to include specifically enumerated agricultural items as well as "all other goods and articles, * * *, and all services, rights, and interests in which contracts for future delivery are presently or in the future dealt in * * *." 1/

1/ Section 2(a)(1) of the Commodity Exchange Act, 7 U.S.C. §2(a)(1).

At the same time, however, Congress sought expressly to preserve the functions of the Securities and Exchange Commission in the markets for debt and equity securities. In specific, the Commodity Exchange Act provides:

"except as hereinabove provided, nothing contained in this section shall (i) supersede or limit the jurisdiction at any time conferred on the Securities and Exchange Commission or other regulatory authorities under the laws of the United States or of any State or (ii) restrict the Securities and Exchange Commission and such other authorities from carrying out their duties and responsibilities in accordance with such laws." 2/

This grant of jurisdiction to the CFTC, together with the preservation of the Commission's traditional jurisdiction over securities, has led to a bifurcated system for regulation of futures contracts, with overlapping jurisdictional responsibilities. Whatever the original intent of Congress with respect to financial futures, it is now apparent that this framework of dual regulation has been the source of much confusion and has decreased the effectiveness of investor protections.

The primary weakness in this regulatory framework stems from the broad definition of the term "commodity", and the grant of "exclusive" jurisdiction to the CFTC over future contracts on commodities. The broad definition of "commodity" employed in the Act has led to much controversy because it can be, and has been, interpreted to include future contracts on traditional securities. This situation has been exacerbated by the fact that the CFTC broadly construes its grant of a measure of "exclusive jurisdiction" as precluding any role for the Commission or the states in regulating futures contract.

2/ Id.

These amendments basically attempt to establish two vertically integrated lines of regulation. The CFTC would have jurisdiction over futures on agricultural commodities and the cash markets for the underlying commodities. The Commission would have jurisdiction over futures on securities and the markets for the underlying securities.

Such a vertically integrated system would have distinct advantages over the present bifurcated system for regulating financial futures. Under the present bifurcated system, there are many surveillance difficulties for both agencies. For example, it is difficult for one agency to discover manipulations in the futures markets directed at the market for the underlying security, and visa versa. Detection of such a manipulation, and subsequent enforcement, would be much more effective if both the market for futures on a security and the market for the underlying security were under the Commission's jurisdiction.

Under the present bifurcated system, there is unequal regulation of two investment strategies with similar functions — futures on securities and options on these same securities. Both are derivative rights in the sense that their prices depend primarily on the prices of the underlying securities. Both are devices for risk management in relation to price fluctuations in the underlying securities. Yet the rules for broker-dealers and marketplaces trading in financial futures are established by the CFTC, and the rules for securities options are established

by the Commission.

Under the proposed system, the rules for both futures on securities and securities options would be set by the Commission. As a result, investors would choose between financial futures and securities options on the basis of their relative economic merits, and not on the basis of less stringent regulation. Under the proposed system, broker-dealers and marketplaces could not "forum shop" for the regulatory jurisdiction with the most lenient rules. Instead, the Commission could develop the most appropriate set of rules for financial futures and securities options, with regard to the protection of investors and the promotion of the public interest.

In addition, the proposed amendments would confirm the Commission's jurisdiction over commodities pools, which raise capital from the public to invest in futures contracts. The capital raising activities of any commodity pool involve the issuance of a "security", as that term is defined by the Securities Act. 3/ And commodity pools investing primarily in financial futures are virtually indistinguishable from mutual funds investing primarily in securities options, which are subject to regulation under the Investment Company Act 4/ as well as the Securities Act. 5/ Under these proposed amendments, all commodity pools would clearly be required to register their securities offerings with the Commission under the Securities Act, and commodity pools investing primarily in futures on securities would be considered mutual funds for the purposes of the Investment Company Act.

3/ See Section 2(1) of the Securities Act of 1933, 15 U.S.C. §2(1).

4/ 15 U.S.C. §80a-1, et seq.

5/ 15 U.S.C. §77a, et seq.

Section by Section Analysis

Section 2(a) of the Bill would amend Section 2 of the Commodity Exchange Act ("Act") by altering the definition of "commodity" contained therein.

Section 2(a) of the bill would insert immediately after the phrase "interests in which contracts for future delivery are presently or in the future dealt in," the following phrase: "but shall not include any 'security' within the meaning of Section 2(1) of the Securities Act of 1933". This amendment would limit the regulatory authority of the CFTC by exempting traditional securities transactions from the jurisdiction of the CFTC.

Section 2(b) of the Bill would amend the Act by deleting the phrase ",except as herein provided," appearing immediately after the phrase "And Provided Further, That". This amendment confirms the jurisdiction of the Securities and Exchange Commission over financial futures on securities and its traditional jurisdiction over capital raising activities such as those engaged in by commodities pools.

Finally, Section 2(c) of the Bill would amend Section 2 of the Act by deleting the word "thereof" appearing immediately after the phrase "unless such transactions involve the sale", and substituting the words "of a commodity (as hereinabove defined)". This amendment to the section would reflect Congress' intention to limit the jurisdiction of the CFTC to the sale of commodities as redefined in the Act and to reserve for other regulatory bodies matters more appropriately within their jurisdiction.