



COMPTROLLER GENERAL OF THE UNITED STATES
WASHINGTON, D.C. 20548

B-146770

APR 5 1978

The Honorable Ed Jones
Chairman, Subcommittee on
Conservation and Credit
Committee on Agriculture
House of Representatives

Dear Mr. Chairman:

Since our appearance and testimony before your Subcommittee on February 23, 1978, there have been some additional developments, including further discussions between representatives of our Office and officials of the Securities and Exchange Commission (SEC), the Commodity Futures Trading Commission (CFTC), the Treasury Department, and other Federal and State agencies, which have prompted us to give further consideration to the question of placement of jurisdiction over futures markets. In our testimony before your Subcommittee, we proposed that CFTC's exclusive jurisdiction over futures trading be retained essentially intact. We did not believe that persuasive arguments had been made or evidence adduced to justify abolishing CFTC and transferring its responsibilities to SEC or to another agency. We were also concerned with the potential for duplicative and burdensome regulation which could result from a division of commodity futures regulation between two or more separate agencies.

We still favor reauthorizing CFTC and preserving its jurisdiction over most types of futures contracts and remain concerned with the need to avoid unnecessarily duplicative and burdensome regulatory requirements. We have, however, become convinced that certain modifications to CFTC's jurisdiction are desirable in order to enhance the integrity and effectiveness of the regulatory process in general and to ensure that the legitimate interests and concerns of other Federal and State agencies are taken into account in the designation of futures contracts and the regulation of futures trading. Accordingly, we would favor amending the Commodity Exchange Act to accomplish the following:

- Transfer to SEC jurisdiction over futures contracts written on all securities subject to the registration requirements of the Securities Act of 1933 (no such futures contracts are now in existence, although a

proposal for a Dow Jones average futures contract is presently pending before CFTC).

- With respect to futures contracts written on securities exempt from the registration provisions of the Securities Act of 1933, provide that SEC shall have the right to bring an enforcement action under sections 17(a), 20, and 22 of the Securities Act of 1933, subject to CFTC's prior right to act.
- With respect to any agreement for future delivery of a commodity subject to the jurisdiction of CFTC, provide that nothing shall affect the jurisdiction of the securities commission or any other authority of any State or territory to prosecute under State antifraud statutes insofar as it does not conflict with the provisions of the Commodity Exchange Act or the rules and regulations thereunder.
- Create an interagency council composed of representatives of CFTC, SEC, Treasury Department, and such other agencies as the President may designate which would serve as a forum for representing and exchanging the views of those agencies interested in and affected by the designation and trading of futures contracts written on securities.

With respect to our first proposal we agree with the arguments made by SEC in its presentations to us (enclosed) and in its recent testimony before the Congress. Specifically, we find merit in SEC's contention that options on registered securities (presently regulated by SEC) and futures contracts on such securities (presently subject to CFTC jurisdiction) are derivative and essentially equivalent and interchangeable financial instruments. SEC argues persuasively that, given its responsibilities for regulation of the underlying cash market in these securities and its authority over options on these instruments, it must, if it is to do an effective job of regulating and protecting the integrity of these markets, also have jurisdiction over futures contracts on such securities. The split or "bifurcated" jurisdiction which presently exists potentially limits the effectiveness of SEC regulatory and surveillance efforts and opens the door to "forum shopping" by those seeking the least stringent or most permissive form of regulation.

As noted, no futures contracts on registered securities have been designated to date. The thrust of this proposed change is, therefore, prospective. It is intended to forestall the kinds of regulatory and market surveillance difficulties which SEC has portrayed in its presentations to us and to the Congress. Because it does not involve existing futures contracts or established futures trading activity, we believe that the division and transfer of regulatory jurisdiction which we are proposing can be accomplished easily and expeditiously, with negligible adverse impact on the industry or on market participants. We believe that the ongoing reauthorization process, with its fundamental and thoroughgoing evaluation of all aspects of futures regulation, affords an ideal opportunity to implement this more logical and efficient division of regulatory jurisdiction before conditions are created which might render such a division more complicated and more onerous to all concerned.

In the case of futures contracts written on unregistered or "exempt" securities, arguments supporting a reallocation of regulatory jurisdiction from CFTC to other agencies can also be made. However, in this area the problems associated with such a transfer are more numerous and difficult while the advantages are, in our view at least, less clear cut and compelling. In contrast to securities which are subject to the exclusive regulatory jurisdiction of SEC, exempt securities are subject to the jurisdiction of a number of Federal agencies (Treasury, GNMA, SEC, etc.) none of which exercises, or to our knowledge has sought to exercise, exclusive regulatory jurisdiction. Furthermore, while no futures contracts have yet been written on registered securities, a number of futures contracts have been written on exempt securities (e.g., Treasury bonds, Treasury bills, short-term commercial paper, and GNMA mortgage certificates) and are currently being actively traded on futures exchanges. Several new exempt security futures contract applications are at the moment pending before CFTC.

Thus, while the transfer of regulatory jurisdiction over registered securities futures from CFTC to SEC is organizationally simple, promotive of regulatory efficiency, and unlikely to have significant impact on market participants, the same cannot be said of a similar reallocation of jurisdiction over exempt securities futures. Most of the agencies which have a direct interest in the exempt securities underlying such futures contracts are unprepared and unequipped to

exercise regulatory control over futures trading in those securities. Nor do we think that such a fragmentation and dispersal of regulatory authority is likely to be effective or beneficial. Such a reallocation would have a substantial immediate impact on exchanges, commission houses, and other market participants and would likely lead in the long run to a number of duplicative and inconsistent regulatory requirements.

With a view to enhancing the protection of market participants from fraudulent and deceptive practices and in order to fill real and potential regulatory gaps, we would also favor amending the act to (1) provide SEC with the right to bring enforcement actions of an antifraud nature in connection with the marketing of futures contracts written on securities exempt from the registration provisions of the Securities Act of 1933, subject to CFTC's prior right to act and (2) provide that the securities commission or any other authority of any State or territory shall have the right to prosecute under its antifraud statutes in cases involving any commodity agreement traded under the Commodity Exchange Act as we are proposing that it be amended. This would allow States to act on cases involving futures contracts on tangible commodities, futures on exempt securities, as well as options written on these futures or on the underlying commodities or exempt securities. Under the Securities Act of 1933 as presently written and interpreted, the States would have this authority over the futures contracts on registered securities which we are proposing be transferred to the jurisdiction of SEC.

Finally, we are proposing that there be created an interagency Council on Regulation of Securities Futures composed of representatives of SEC, the Treasury Department, CFTC, and such other agencies as the President may deem appropriate, whose function it would be to ensure proper representation and consideration of the interests of these agencies in the regulatory actions undertaken by (1) CFTC with respect to futures on exempt securities and (2) SEC with respect to futures on registered securities.

The Council would concern itself with proposals for the designation of new registered and exempt securities futures as well as such policy-related market surveillance and regulatory questions as may arise from time to time in connection with the trading of existing securities futures. The Council

arrangement envisions the maintenance of continuous liaison and information exchange between and among its members for the purpose of promoting efficiency, coordination, and consistency in the formulation of overall Government policy. Formal meetings of the Council members would take place according to a schedule and frequency agreed on by the Council members and on an ad hoc basis in response to specific questions or issues which one or more members may wish to bring before the Council. Decisions of the Council would be advisory to CFTC and SEC.

We are enclosing suggested language which would amend the act to accomplish the changes we are proposing.

We are sending a similar letter today to the Chairman, Subcommittee on Agricultural Research and General Legislation, Senate Committee on Agriculture, Nutrition, and Forestry. Copies of this letter are being sent to the Secretary of the Treasury, the Secretary of Housing and Urban Development, the Director of the Office of Management and Budget, and to the Chairmen of CFTC and SEC.

Sincerely yours,

(SIGNED) ELMER B. STAATS

Comptroller General
of the United States

Enclosures - 3

A BILL

To improve the regulation of the commodity futures market and provide for consultation and coordination among the securities regulatory authorities.

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

Short title

Section 1. This Act may be cited as the "Commodity Futures Trading Improvement Act of 1978"

Section 2

Section 2(a)(1) of the Commodity Exchange Act (7 U.S.C. §2), as amended, is further amended as follows:

(1) By inserting, 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 subject to the registration provisions of the Securities Act of 1933, or any index composed of any such security or group of securities. An agreement shall include any contract for future delivery, and also shall include 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.'"

(2) By deleting the language beginning with the phrase: "Provided that the Commission shall have exclusive jurisdiction" and ending with "other authorities from carrying out their duties and responsibilities in accordance with such laws.", and substituting the following provisions:

"(A) With respect to any agreement for future delivery of a commodity, except as provided in subparagraph (C) of this section, the Commodity Futures Trading Commission shall have exclusive jurisdiction to administer the provisions of this title: Provided, however, that nothing in this title shall affect the jurisdiction of any agency or authority of any state or territory to bring an action to enforce any state statute prohibiting or punishing fraudulent activities insofar as such agency or authority does not take action which conflicts with the provisions of this title or the rules and regulations thereunder.

"(B) Any agreement for future delivery of any security subject to the registration provisions of the Securities Act of 1933, or any agreement for future delivery of any

index composed of any such security or group of securities, shall not be regarded as a commodity but shall be deemed a security for purposes of registration and regulation by the Securities and Exchange Commission pursuant to the provisions of the Securities Act of 1933, the Securities Exchange Act of 1934, the Investment Company Act of 1940, and the Investment Advisers Act of 1940.

"(C) With respect to any agreement for future delivery of any security not subject to the registration and regulation provisions of the Securities Act of 1933, the Commodity Futures Trading Commission shall exercise its authority to administer the provisions of this title,

(1) Provided that the Securities and Exchange Commission may institute any enforcement action or proceeding under Sections 17(a), 20, and 22 of the Securities Act of 1933, with respect to any agreement for future delivery of any security not subject to the registration and regulation provisions of the Securities Act of 1933; and

(2) Provided further that, with respect to any enforcement action or proceeding brought under subparagraph (C)(1) of this section, the Securities and Exchange Commission shall inform the Commodity Futures Trading Commission immediately after the issuance of a formal order of investigation, and shall inform the Commodity Futures Trading Commission at least 10 business days before instituting an administrative proceeding or filing a complaint in any court. No action under subparagraph (C)(1) and (2) may be taken by the Securities and Exchange Commission if within such 10 day period the Commodity Futures Trading Commission institutes an administrative proceeding or files a complaint in any court regarding the matters of which it was notified. The Commodity Futures Trading Commission may, in writing, waive this notification procedure."

Section 3

The Commodity Exchange Act (7 U.S.C. §1 et seq.), as amended, is further amended by adding to the end thereof the following new title.

Title V - Council on Regulation of Securities Futures

Purpose

Sec. 501. It is the purpose of this title to establish a Council on Regulation of Securities Futures which shall consider and recommend upon applications for designation of futures contracts written on securities instruments, advise on whether such designations should be continued, and make recommendations concerning the regulation of trading in such contracts, and ensure coordination and consultation among the securities regulatory agencies.

Definitions

Sec. 502. As used in this title--

- (1) the term "securities regulatory agencies" means the Department of the Treasury, the Securities and Exchange Commission, the Commodity Futures Trading Commission and any other interested Federal agencies as shall be designated from time to time by the President.
- (2) the term "Council" means the Council on Regulation of Securities Futures.

Establishment of the Council

Sec. 503. (a) There is established the Council on Regulation of Securities Futures which shall consist of--

- (1) the Secretary of the Treasury,**
- (2) the Chairman of the Securities and Exchange Commission,**
- (3) the Chairman of the Commodity Futures Trading Commission, and**
- (4) such additional members as the President shall from time to time designate. The President shall specify the term of membership of such additional members.**

(b) The Secretary of the Treasury shall be the first Chairman of the Council. The President shall, on a rotating basis, designate each succeeding Chairman of the Council.

(c) The terms of the Chairmen of the Council shall be 1 year.

(d) The members of the Council may from time-to-time designate other officers or employees of their respective agencies to carry out their duties as members of the Council.

(e) Each member of the Council shall serve without additional compensation but shall be entitled to reasonable expenses incurred in carrying out his official duties as such a member.

Sec. 504. Functions of the Council

Subject to section 505(b)--

(a) The Council shall consider and make recommendations upon those matters that come before it under subsection (b) and subsection (c) of this section. The Council may consider and make recommendations on actions including, but not limited to, modifications in contract terms and specifications, market surveillance, monitoring of trading, trade practice investigations, and regulatory market interventions, including the taking of emergency actions.

(b) The Commodity Futures Trading Commission and the Securities and Exchange Commission shall, immediately upon receipt of an application for initial designation of contract markets in futures contracts written on securities subject to section 2(a)(1)(A) and (B) of the Commodity Exchange Act (7 U.S.C. §2), and within a reasonable time before taking any action which the Council may consider pursuant to subsection (c) refer such application or action (including supporting documentation) to the Council for consideration and recommendation. Each member of the Council shall be notified in writing by the Commodity Futures Trading Commission and the Securities and Exchange Commission of any matter referred to the Council.

(c) The Council, upon petition of one of its members, shall also consider and make recommendations regarding the

advisability of any action taken or which could be taken by a member affecting the regulation of futures contracts on securities instruments.

Section 505. Recommendations and Response

(a) When a recommendation of the Council is found unacceptable by one or more of the applicable member Federal agencies, the agency or agencies shall within a reasonable time after the recommendation is transmitted to it (but not later than 45 days) submit to the Council a written statement of the reasons the recommendation is unacceptable.

(b) Nothing in this title shall preclude the Commodity Futures Trading Commission or the Securities and Exchange Commission from taking any action on a matter subject to section 504 when the applicable Commission determines that the action cannot await referral to the Council or receipt of the Council's recommendations.

Administration

Sec. 506. In carrying out the functions of the Council, the Chairman may utilize, with the consent of the Council and to the extent necessary, the personnel, services, and facilities of the member Federal agencies. The costs of operation of the Council shall be borne equally by the member agencies.

Access to Information by the Council

Sec. 507. For the purpose of carrying out this title, the Council upon majority vote of the members shall have access to all books, accounts, records, reports, files, memoranda, papers, things, and property belonging to or in use by member Federal securities regulatory agencies, including reports of investigations, economic analysis, together with workpapers and correspondence files related to such reports, whether or not a part of the report, and all without any deletions.

Sec. 508. The Council in any of its actions or deliberations shall not be subject to the Administrative Procedure Act (5 U.S.C. 551 et seq., 701 et seq.).