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MEMORANDUM

April 12, 1978

TO: Harold M. Williams, Chairman
Harvey L. Pitt, General Counsel
Office of the General Counsel
Ralph C. Ferrara, Executive Assistant
Chairman's Office
Andrew L. Rothman, Director
Office of Public Affairs

FROM: Robert C. Pozen, Assistant General Counsel
Office of the General Counsel

RE: Proposed Legislation on CFTC

REP

As you may already know, the General Accounting Office ("GAO") has proposed legislation that incorporates some, but not all, of our suggestions for a reallocation of regulatory jurisdiction over futures contracts. Enclosed is a copy of the legislation proposed by GAO, and the accompanying letter sent by GAO to the Subcommittee on Conservation and Credit of the House of Representatives Committee on Agriculture, and the Subcommittee on Agricultural Research and General Legislation of the Senate Committee on Agriculture, Nutrition, and Forestry.

Members of these two Subcommittees have also asked the Commission to provide drafting assistance on legislation that would reflect both the interests of the Commission and the CFTC. Therefore, the Commission must decide whether to support the GAO proposal in total, or to draft modifications to the GAO proposal for these Subcommittees. This decision can be fruitfully analyzed in three parts: (1) futures contracts on registered securities; (2) futures contracts on agricultural commodities, and (3) futures contracts on exempt securities.

I. Futures Contracts on Registered Securities

With regard to futures contracts on registered securities, the Commission has attained almost all of its objectives in the proposed GAO legislation. The only potential problem is that the Advisory Council proposed by the GAO would be empowered to advise the Commission as to futures contracts on registered securities as well as to advise the Commodity Futures Trading Commission ("CFTC") as to futures contracts on commodities. However, the powers of the Advisory Council are quite limited. At worst, the Commission would have to provide the Council with a written explanation for rejecting its recommendations; and the Commission would be obliged to provide the Council with data, including

investigation reports, relating to futures trading under the Commission's jurisdiction. Moreover, from the viewpoint of the officials at the GAO, the Advisory Council is the centerpiece of their legislative proposal.

Thus, the Commission should probably not oppose the concept of an Advisory Council. The two main alternatives seem to be: a) support the GAO's proposal for an Advisory Council, despite its broad coverage, as part of the legislative compromise; or b) support the GAO's proposal for an Advisory Council, but only with regard to futures contracts on tangible commodities and/or exempt securities.

II. Futures Contracts on Tangible Commodities

With regard to futures contracts on tangible commodities, the GAO proposal is generally consonant with the Commission's position. But, the staff members of the GAO were unwilling to take an express position on interests in commodity pools that invest primarily in futures contracts on tangible commodities. It may be best not to raise expressly the subject of interests in commodity pools because the silence of the proposed GAO legislation arguably leaves the Commission with jurisdiction over such interests. Such interests in commodity pools would appear to meet the criteria for investment contracts, and thus would constitute securities subject to registration under the Securities Act of 1933. In other words, the interests are in the pools and not in the commodities, so that these interests are not affected by legislation about agreements with respect to futures contracts on commodities.

On the other hand, it might be argued that the proposed legislation confers exclusive jurisdiction on the CFTC with respect to any agreement relating to future delivery of a commodity, which should include any agreement with respect to the establishment of a pool investing primarily in such commodities. This argument would be bolstered by the legislative history of the proposals, which are aimed at integration of regulatory jurisdiction of all derivative rights based on the same underlying commodity or security. Thus, the Commission should at least ask for a statement in the legislative history that this legislation in no way affects the traditional jurisdiction of the Commission over interests in commodity pools.

III. Futures Contracts on Exempt Securities

With respect to futures contracts on exempt securities, the legislation proposed by GAO raises three sets of questions of concern to the Commission. First is the role of the Commission in rulemaking and contract designation by the CFTC with respect to futures contracts on exempt securities. Under the GAO proposal, the Commission's role in these matters would be limited to participation in the Advisory Council, which would not be able to require action on the part of the CFTC.

If the Commission took the position, discussed above, that the jurisdiction of the Advisory Council should be limited to futures contracts on tangible commodities and/or exempt securities, the Commission might want to suggest broader powers for the Advisory Council — e.g., veto power over contract designations by the CFTC. Of course, the Commission should object to broadening the powers of the Advisory Council if, as proposed by the GAO, the jurisdiction of the Council extended to futures contracts on registered securities.

Second is the Commission's role in enforcement with respect to futures contracts on exempt securities. The Commission originally suggested to GAO that the Commission should be permitted to enforce Section 10(b) of the Securities Exchange Act with respect to futures contracts on exempt securities. However, this suggestion was rejected by the GAO staff because Section 10(b) generally allowed the Commission to promulgate rules, and specifically encompassed market manipulations that might occur on a board of trade. Instead, the GAO staff acquiesced to Commission enforcement of Section 17(a) of the Securities Act, because that Section appeared to them to deal only with offers and sales of securities by broker-dealers to investors. Moreover, the GAO staff insisted on a first right of refusal to enforce by the CFTC. At first, the GAO agreed that the Commission would be obliged only to provide prior notice of any enforcement action to the CFTC. Upon the urging of Comptroller General Staats, however, the GAO staff finally proposed that the Commission may not take any enforcement action if the CFTC, after receiving notice from the Commission, decides to institute its own enforcement action.

The Commission should consider various modifications to the proposed enforcement role of the Commission with respect to exempt securities.

- A. The Commission could ask for the right to enforce Rule 10b-5 on the grounds that this Rule, unlike Section 10(b), does not expressly empower the Commission to issue regulations.
- B. The Commission could ask for a deletion of the first right of refusal to enforce on the grounds that the CFTC, after receiving notice from the Commission, should coordinate any enforcement action with the Commission.
- C. The Commission could ask for a shorter notice period, such as three business days, on the ground that time is of the essence in enforcement matters.
- D. The Commission could ask that the first right of refusal to enforce be conditioned on the institution of an equivalent enforcement action by the CFTC and the vigorous pursuit of such action by the CFTC.

Third is the question of commodity pools that invest primarily in futures contracts on exempt securities. The GAO staff was unwilling to take a position on such commodity pools. As discussed above, there is a strong argument that interests in such commodity pools are securities subject to registration under the Securities Act. Moreover, if commodity pools invest primarily in futures contracts on exempt securities, they would appear to meet the criteria for an investment company in Section 3 of the Investment Company Act. On the other hand, the CFTC may argue that exempt securities are included within the statutory definition of commodity, and therefore commodity pools investing in futures contracts on such commodities should come within the CFTC's exclusive jurisdiction. Moreover, CFTC may argue that futures contracts on exempt securities are not themselves securities, and therefore commodity pools investing primarily in such futures contracts do not meet the criteria for an investment company.

Again, commodity pools confront the Commission with difficult choices in terms of legislative strategies. There is a substantial risk that the Commission may lose if it asks for express authority over commodity pools investing primarily in futures contracts on exempt securities, but legislative silence on this subject may be subsequently used against the Commission. Perhaps the best approach is to ask for language in the legislative history making clear that this legislation preserves the current law with respect to commodity pools. .