PREPARED STATEMENT OF RALPH C. FERRARA, GENERAL COUNSEL, SECURITIES AND EXCHANGE COMMISSION, BEFORE THE SUBCOMMITTEE ON CONSERVATION AND CREDIT OF THE HOUSE OF REPRESENTATIVES COMMITTEE ON AGRICULTURE CONCERNING INTERAGENCY COOPERATION

(February 12, 1980)

Mr. Chairman, and members of the Subcommittee:

In response to the request of Chairman Jones, I am pleased to appear before the Subcommittee to discuss the working relationship between the Securities and Exchange Commission (the "Commission") and the Commodity Futures Trading Commission ("CFTC"). In my statement today, I will review the areas in which the two agencies have cooperated. I will also bring to the Subcommittee's attention certain areas of regulatory overlap which are of concern to the Commission and which may give rise to problems in the future.

As this Subcommittee is aware, in the Futures Trading Act of 1978, Congress amended the Commodity Exchange Act to require the CFTC to consult with the Commission, as well as with the Department of the Treasury and the Board of Governors of the Federal Reserve System, on CFTC activities relating to the responsibilities of each respective agency. In accordance with this Congressional directive, the CFTC and the Commission have maintained lines of communication between the members and staff of the two agencies.

In 1978, the Commission, the CFTC, Treasury, and the Board of Governors established a Policy Group on Financial Instrument Futures to which a policy-level representative was appointed by each participant. The Policy Group was organized to discuss broad policy aspects of mutual concern to its participants, with a particular focus on contract market applications involving financial futures and stock index contracts.

In an effort to coordinate the regulatory process, the Policy Group has undertaken a study to compare the regulatory objectives and programs in the securities field, as administered by the Commission and the Board of Governors, with the regulatory objectives and programs in the commodities field, as administered by the CFTC. As an initial step, the staffs of the Commission and the CFTC have each prepared for the Policy Group working papers explaining in some detail the respective regulatory requirements under the federal securities and commodities laws which seek to promote the protection of investors. In this connection, the staff of the Board of Governors has prepared a working paper on margin regulation, and the staff of the Commission is currently drafting a working paper describing relevant aspects of its surveillance and enforcement system.

These initial working papers on investor protection, margin, and market surveillance will form the basis for a second phase of the study in which a comparative analysis of the regulatory schemes of the Commission and the CFTC will be carried out. Through this approach, we intend to identify material differences in these regulatory schemes and hope to reach some conclusions on whether regulatory disparities may have an adverse impact on the capital allocation decisions of market professionals and investors. If there is such an impact, we intend then to address whether regulatory disparities can be justified on public policy grounds, and whether the regulatory schemes for securities and financial futures can be better rationalized to eliminate undesirable regulatory gaps or unnecessary duplication of effort.

To promote greater understanding of the financial futures and securities markets, the Policy Group has thus far sponsored two seminars attended by senior officials and staff members of the respective agency participants.

In December of 1978, the Policy Group arranged a seminar on financial futures markets at which CFTC staff members and representatives of four financial institutions made presentations. Also in December, the director and staff members of the Commission's Special Study of the Options Markets explained to CFTC staff members some of the major findings and recommendations of the Special Study.

On a more informal basis, staff members of the Commission and the CFTC have consulted with each other on specific regulatory matters. As a result of inter-staff consultation, the Commission and the CFTC have amended their respective net capital and minimum financial rules to provide a measure of uniformity for firms which are dually-registered as securities broker-dealers and as futures commission merchants. Thus, the CFTC, in amending its minimum financial rules, has essentially adopted the Commission's approach for valuing securities positions. Similarly, the Commission has revised its net capital rule to conform to the CFTC's rules governing the valuation of futures positions. The financial reporting rules of the two agencies have also been harmonized in some respects. The CFTC has by rule permitted dually-registered firms to file quarterly "FOCUS" filings made by those firms with the Commission. We, in turn, have permitted dual-registrants to include in their quarterly "FOCUS" filings a "Schedule of Segregation Requirements" devised by the CFTC.

In the area of enforcement, staff members of the Commission's Division of Enforcement from time to time have brought to the attention of the CFTC's Division of Enforcement matters which may involve violations of the Commodity Exchange Act. Similarly, staff of the Commission's Office of Economic and Policy Research and staff of the CFTC's Division of Economics and Education

have from time to time consulted with each other and exchanged memoranda on various issues of common interest.

In addition, the Commission and the CFTC have recently been asked to participate in an intergovernmental group to work with the Internal Revenue Service in regard to certain tax avoidance schemes involving futures or options. For example, silver straddles have been utilized primarily for tax avoidance purposes without any bona fide investment purpose. Similar problems could arise in the options markets.

Notwithstanding these cooperative efforts, and the good faith of all parties involved, the Commission remains concerned that the regulatory overlap of the Commission and the CFTC may give rise to future problems as additional types of financial futures contracts are approved for trading by the CFTC. Of immediate concern to the Commission in this regard is the pending application of the Kansas City Board of Trade ("KCBT") for designation as a futures contract market for a stock index. The Commission has submitted comments and has testified before the CFTC with respect to the KCBT's initial proposal to trade a contract based on the Dow Jones 30 Industrial Stock Average. Later this month, the Commission intends to submit its comments on the revised contract submission of the KCBT to trade a contract based on the Value Line Stock Average. In our comments, we intend to discuss the functional similarities of index futures and stock options, to raise questions about regulatory disparities between financial futures and securities options and the implications for the nation's capital formation process, and to apprise the CFTC of the lessons we have learned from our Options Study about the regulation of derivative securities.

Our reservations concerning the KCBT contract submission are heightened by the prospect that CFTC approval may pave the way for index contracts on smaller groups of stocks and perhaps even to futures on single stocks. We understand that the Chicago Mercantile Exchange, for example, intends to apply to the CFTC for contract market designation in a number of stock index contracts based upon different industrial categories.

As the number and type of financial futures instruments expand, we are likely to witness a corresponding growth in the number of pools which are formed to channel investors' savings into these instruments. The creation of those financial futures pools gives rise, among other things, to questions concerning the applicability of the Investment Company Act to such pools, and the applicability of the Investment Advisers Act to their advisers. As the Subcommittee may be aware, the staff of the Commission, in a discretionary action, recently took a no-action position on the applicability of the Investment Company and Advisers Acts to a pool whose holdings were limited to futures on securities which are exempt from the registration requirements of the federal securities laws — namely, Treasury bills, notes and bonds, GNMA certificates, and short-term commercial paper. The Commission declined a request by the Investment Company Institute to reconsider the staff's position, and the matter may ultimately be litigated. The staff in its no-action letter pointed out that the underlying securities, in view of their exempt status, were beyond the traditional regulatory concerns of the Commission. In contrast, approval by the CFTC of trading in futures on single equity securities or indexes comprised of such securities would involve securities over which the Commission has been entrusted with broad regulatory authority.

Furthermore, the CFTC recently adopted rules governing, among other matters, disclosure requirements for commodity pool operators and commodity trading advisers. But the Commission had not been afforded the opportunity to comment on these proposals before they were adopted in April of 1979. When the disclosure of the historical performance of the trading adviser began appearing in commodity pool prospectuses filed under the Securities Act of 1933, the Commission's staff took serious exception to the adequacy and accuracy of the CFTC mandated disclosure. Our staff informed the CFTC of the nature and extent of our problems with their disclosure requirement. To the best of our knowledge, the CFTC staff has now tentatively agreed to revise their requirements and to give this agency the opportunity to comment on their revised proposals.

We will, of course, endeavor to resolve these concerns through communications with the CFTC. Thus, we have been submitting comments to the CFTC on its proposals for stock index futures, and we allowed the CFTC to make a submission to the Commission before deciding to issue the above mentioned no-action letter under the Investment Company Act and the Investment Advisers Act. However, if our comments are not taken into account and our regulatory concerns are not resolved, it may then be necessary for Congress to reconsider the allocation of jurisdiction with respect to financial futures, especially futures on equity securities and stock indexes, and to bring the regulatory scheme for such futures in line with the current framework for securities options.

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I thank you again for the opportunity to address this Subcommittee, and I shall be happy to respond to any questions.