

M E M O R A N D U M

March 10, 1981

TO: George Simon
FROM: Gene Carasick *GC*
SUBJECT: Jurisdiction over New Options Products

Attached for transmittal to Doug is the redraft incorporating your changes of our brief summary of the Commission jurisdiction over new options products under the federal securities and commodities laws.

Commission Jurisdiction over New Options Products

A finding that the Commission has jurisdiction over a new options product requires a determination that: (1) the Commission has jurisdiction over the product under the federal securities laws, and (2) that jurisdiction is not revoked by the Commodity Exchange Act.

(1) Federal securities laws

With regard to the first determination, the focal question is whether the proposed new options product is a security. In the New Products Memorandum, ___/ the principal argument for asserting jurisdiction over the various new options products was premised on the status of the underlying instrument. The definition of the term "security" in Section 3(a)(10) of the Securities Exchange Act (the "Act"), in addition to listing several instruments deemed to be securities, includes the "right to subscribe to or purchase any of the foregoing." On this basis, we concluded that Commission jurisdiction over options on debt securities, such as GNMA's and Treasury instruments, was clear. It also was clear that this approach could not be relied on to conclude that the Commission had jurisdiction over options on non-securities, such as foreign currency and precious metals. Moreover, this analysis left somewhat unsettled Commission jurisdiction over options on such instruments as commercial paper, which depending on the circumstances may or not be a security, ___/ and

___/ See Memorandum to the Commission from the Office of the General Counsel and the Division of Market Regulation, dated January 27, 1981 ("New Products Memorandum").

___/ Section 3(a)(10) of the Act states that the term security "shall not include . . . any note . . . which has a maturity at the time of issuance of not exceeding nine months." In interpreting this literal exclusion of certain commercial paper from the definition of the term security, the Courts and the Commission have looked to Section 3(a)(3) of the Securities Act which exempts from certain provisions of that Act "(a)ny note . . . which arises out of a current transaction or the proceeds of which have been or are to be used for current transactions, and which has a maturity at the time of issuance of not exceeding nine months." For purposes of registration under the Securities Act, the Commission has interpreted this exemption to apply only to: (1) prime quality commercial paper; (2) not ordinarily purchased by the general public; (3) issued to facilitate well-recognized types of current operational business transactions; and (4) eligible for discount at Federal Reserve Banks. Securities Exchange Act Release No. 4412 (September 20, 1961). Courts generally also have relied on these criteria to determine whether commercial paper is a security under Section 3(a)(10) of the Act. See Sanders v. John Nuveen & Co., 463 F.2d 1073 (7th Cir.), cert. denied, 409 U.S. 1009 (1972).

certificates of deposit ___/ the status of which has not yet been resolved. ___/

With respect to options on non-securities, the New Products Memorandum stated that "the only basis for Commission regulation would appear to be that the package of interests -- the underlying commodity or cash, the option itself, and the guaranty of performance of the clearing agency -- constitutes an 'investment contract,' and hence a security." ___/ After examining the "investment contract" case law, however, the memorandum concluded that "we believe the stronger view to be that an exchange-traded option on such an instrument, without more, is not a security." ___/

During the Commission's discussion of the New Products Memorandum, members of the Commission (particularly Commissioner Friedman) and Ralph Ferrara shared the reservations you have expressed concerning this legal analysis. A consensus of opinion appeared to emerge that the analysis contained in the New Products Memorandum generally represented the most conservative of possible assessments. By approaching the question of jurisdiction less from a narrow textual perspective and more from a policy-oriented perspective, however, a fairly persuasive argument can be made for Commission authority over options on non-securities under certain circumstances. In particular, if a standardized options contract (i) is traded on a national securities exchange, (ii) marketed by broker-dealers, (iii) settled and cleared by the Options Clearing Corporation, and (iv) designed as and registered with the Commission as a security, we believe that such an option may be deemed a separate security under Section 3(a)(10) of the Act,

___/ There is currently a conflict among the federal Circuit Courts as to whether a certificate of deposit is a security. The Commission's position is still in the formative stage. See Supplemental Memorandum of the SEC as amicus curiae, Schutte v. Bank of Miami, No. 79-3607 (5th Cir., filed May, 1980).

___/ In addition, it is unclear whether this approach would provide a basis for Commission jurisdiction on an option on a stock index, or any other type of option that provides for cash settlement only. See New Products Memorandum at 5-6.

___/ New Products Memorandum at 12.

___/ New Products Memorandum at 2.

if not as "an investment contract," then as an "instrument commonly known as a 'security'." ___/

(2) Commodity Exchange Act

Notwithstanding the fact that the federal securities laws can be interpreted as conferring to the Commission broad jurisdiction over options on financial instruments, that authority may be revoked by the provisions of the Commodity Exchange Act ("CEA"). ___/ Under Section 2(a)(1) of the CEA, the CFTC is granted sole authority to regulate futures contracts on any "commodity." ___/ This provision, in addition, grants to the CFTC exclusive jurisdiction over all agreements, including options transactions, "involving contracts of sale of a commodity for future delivery." ___/ This express grant of exclusive jurisdiction

- ___/ Of course, this analysis logically could extend Commission jurisdiction to standardized exchange options trading on any instrument, whether security or non-security. The Commission would be confronted with the question of where, as a policy matter, to draw the line beyond which it would decline jurisdiction.
- ___/ This aspect of the jurisdictional analysis did not evoke any discussion at the Commission meeting on the New Products Memorandum.
- ___/ The term "commodity" as defined in Section 2(a)(1) includes, in addition to a number of specifically identified agricultural products, "all services, rights, and interests in which contracts for future delivery are presently or in the future dealt in." Literally interpreted the term "commodity" could be deemed to encompass any security, including stock, on which futures contracts are traded. Whether the authority of the CFTC was intended to reach this far, however, is unresolved by the legislative history.
- ___/ Section 2(a)(1) of the CEA states that the CFTC "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 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, exchange, or market."

preempts any authority which otherwise might be exercised by the Commission with respect to any option transaction that is within the scope of the provision, even though the option itself also may be a security under the federal securities laws. ___/

Although it is somewhat unclear whether this grant of exclusive jurisdiction encompasses options on the underlying "commodities" in addition to options in futures contracts, there is little doubt that options on the underlying commodities are subject to the Congressionally imposed commodity options ban of Section 4c(c) of the CEA. ___/ Accordingly, under this provision it would appear that a securities exchange could not proceed to trade an option on an instrument that qualifies as a commodity at least until the CFTC acted to remove the commodity options ban. ___/

___/ The exclusive jurisdictional grant in Section 2(a)(1) is followed by language which states that "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 (ii) restrict the Securities and Exchange Commission . . . from carrying out [its] duties and responsibilities" (emphasis added). The underscored phrase, however, indicates that this provision was not designed to detract from the preceding grant of exclusive jurisdiction.

___/ Section 4c(c) states that "no person may . . . offer to enter into, enter into, or confirm the execution of any commodity option transaction involving any commodity regulated under this Act but not specifically set forth in Section 2(a) of this Act" until (1) the CFTC transmits to Congress "documentation of its ability to regulate successfully such transactions, including a copy of the Commission's proposed rules and regulations," and (2) "the expiration of thirty calendar days of continuous session of Congress after the date of such transmittal."

___/ By authorizing the CFTC to promulgate regulations governing commodity options transactions, the commodity options ban represents an additional grant of CFTC jurisdiction over commodity options. It is unclear, however, whether the grant of jurisdiction is exclusive. In contrast to Section 2(a)(1), it does not expressly grant exclusive jurisdiction to the CFTC. Nevertheless, it can be argued that, because only action by the CFTC can lift the ban, it was intended that the CFTC exercise exclusive authority.

Both the grant of exclusive CFTC jurisdiction over commodity options and the commodity options ban, however, are circumscribed by the so-called "Treasury exclusion" in Section 2(a)(1). This provision, adopted at the request of the Treasury Department, ___/ states that:

Nothing in this Act 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 for future delivery conducted on a board of trade (emphasis added).

This language was relied on in the New Products Memorandum to conclude that, with respect to the enumerated instruments, the jurisdiction of the CFTC was limited to futures transactions conducted on a board of trade. Moreover, on the basis of this language, the memorandum concluded that, notwithstanding the American Board of Trade case, ___/ the commodity options ban similarly did not extend to options on the enumerated instruments including government securities and options on foreign currency.

In approving the CBOE GNMA options proposal, the Commission, without analysis, explicitly determined that "the CEA is not applicable to the trading of options on GNMA securities, particularly where the securities are traded on a national securities exchange." ___/ To the extent this conclusion is based

___/ See letter to Herman E. Talmadge, Chairman, Senate Committee on Agriculture and Forestry, from Donald L.E. Ritger, Acting General Counsel, Department of the Treasury, dated July 30, 1974. Reprinted in S. Rep. No. 93-1131, 93rd Cong., 2nd Sess. at 49.

___/ In CFTC v. American Board of Trade, Inc., 473 F. Supp. 1177 (S.D.N.Y. 1979) the District Court found that, since the exclusion applies only to "transactions in foreign currency" (as opposed to transactions involving foreign currency), it was intended to encompass cash market transactions only, and does not exclude from CFTC jurisdiction transactions in options on foreign currency.

___/ Securities Exchange Act Release No. 17577 (February 26, 1981), note 13.

on the rationale advanced in the New Products Memorandum, the Commission, in effect, also has resolved the question of CFTC jurisdiction over options on Treasury instruments, foreign currency or any of the other instruments specified in the Treasury exclusion. ___/

This analysis of the "Treasury exclusion" would appear to foreclose CFTC jurisdiction over all of the new options products on which exchange filings have been received or are anticipated, including stock index options, ___/ Treasury options and foreign currency options. Options on instruments not enumerated in the exclusion that are commodities, such as precious metals, would be subject at least to the concurrent, if not to the exclusive, jurisdiction of the CFTC, regardless of their status under the federal securities laws.

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___/ This was the thrust of Tom Russo's argument on behalf of the Philadelphia Stock Exchange ("Phlx") at the February 23, 1981 meeting with the staff concerning the Phlx proposal to trade options on foreign currency. Mr. Russo also contended that the Commission had affirmative jurisdiction over standardized exchange trading of options on foreign currency, even though the underlying instruments are not securities.

___/ To apply this argument to stock index options or to stock options themselves, such instruments presumably would have to qualify as "security rights."