

May 20, 1981

COMMISSION RESPONSE TO CBOT'S PROPOSED
EQUITY PORTFOLIO FUTURES CONTRACT

I. Introduction

A. Reference previous comments and note heightened concern over portfolio contract based on 5 equity securities. Strong statement opposing approval of the contract.

B. Overview of Comments

- 1) Equity portfolio future is a security -- namely, a "certificate of interest or participation in" stock.
- 2) Under the Commodity Exchange Act, the SEC retains jurisdiction to apply the regulatory scheme of the federal securities laws if the contract is approved.
- 3) The contract would have an adverse impact upon the equity securities markets by --
 - a) creating the potential for manipulative abuses,
 - b) injecting disorderliness into the securities markets.
 - c) seriously interfering with the Commission's responsibility, in conjunction with securities SRO's, to oversee and surveil all trading in the equity securities markets, and to monitor the activities of all participants in those markets,
- 3) The contract would have a deleterious impact on investor protection.
- 4) The contract lacks an economic purpose and is not in the public interest.

II. Jurisdictional Argument

A. The portfolio futures contract is a security under federal securities laws

- 1) Definition of security under '33 and '34 Acts
- 2) Utilize an economic realities analysis
(United Housing Foundation, Inc. v. Foreman;

Affiliated Ute Citizens v. U.S.; Tcherepnin v. Knight; Teamsters v. Daniel; SEC v. C. M. Joiner Leasing Corp).

- 3) Definitions are to be read flexibly and broadly. Tcherepnin; Howey; Joiner.
 - 4) While a portfolio futures contract may constitute other types of securities as well, the contract is a "certificate of interest or participation in" a stock.
 - a) Discuss legislative history.
 - b) Since the value of the future is linked to the pricing of underlying securities, from the standpoint of those who buy and sell a portfolio future, the instrument is a "certificate of interest or participation in" the underlying stocks.
 - c) Also, as a matter of economic reality, a portfolio future is equivalent to a "right to purchase" a stock or, in other words, an option.
 - (i) Portfolio future is designed to serve the same hedging function as an option.
 - (ii) Cash only settlement does not detract from the equivalency of an equity portfolio future and an equity option. The great preponderance of options traded on exchanges are offset prior to their exercise date.
 - (iii) Congress in 1978 recognized that futures on stock are economically equivalent to stock options.
- B. The Commission retains jurisdiction over an equity portfolio future, notwithstanding the exclusive jurisdiction provision of CEA -
- 1) Cite SEC savings clause in CEA §2.
 - 2) To negate SEC jurisdiction over persons and markets trading securities would violate a fundamental canon of statutory construction that a statute should be interpreted so as not to render one part inoperative

(Colautti v. Franklin; U.S. v. Menasche;
Nat'l Ass. of Recycling Industries v.
ICC; Motor & Equipment Mfrs. Ass. v. EPA).

- 3) Statements on House and Senate floor by Poegue and Talmadge following the Conference Committee's action in 1974 supports assertion of SEC jurisdiction.

- a) Statement also indicates that Congress intended to limit SEC's jurisdiction with regard to calling commodity futures investment contracts. Here we do not base our jurisdiction on the fact that these are investment contracts. (Though they might be).

- 4) CFTC has no jurisdiction over an instrument which does not provide for the opportunity to accept delivery of underlying commodity.
(Problem: Market Regulation is considering cash settlement for options on Treasury bills.)

C. Consequences of approval of contract: Since the SEC would have jurisdiction over these securities, the Commission would take whatever action it feels is necessary to ensure its ability to adequately regulate the equity markets. These may include:

- 1) exercising authority under Sections 9(b) and 23 of 1934 Act to prohibit trading of equity portfolio futures;
- 2) requiring the CBOT to register with the Commission under the '34 Act and requiring it to adopt fair practice rules, suitability rules, etc.;
- 3) requiring the CBOT's clearing corporation to register the futures under the '33 Act;
- 4) requiring brokers and dealers in such futures to register with the Commission under the '34 Act;
- 5) requiring companies and individuals, who invest and advise in these futures, to register with the Commission under the Investment Company and Investment Advisers Acts;
- 6) enforcing the Commission's antifraud provisions (e.g. against insider trading);

- 7) requiring broker-dealers to comply with Commission recordkeeping, financial responsibility, etc. requirements;
- 8) subjecting broker-dealers and CBOT to Commission inspections.

III. Trading of the Equity Portfolio Contract will have Deleterious Affects on the Securities Markets and the Commission's Oversight Responsibilities with respect to those Markets.

A. The Commission's role as the overseer of the nation's equity markets.

- 1) '34 Act legislative history
- 2) '75 Act legislative history
- 3) 1963 Special Study
- 4) Options Study
- 5) Cases on ---
 - a) Commission's expertise
 - b) Deference to Commission with regard to predictive findings, e.g., Bradford.

B. Contract has potential for manipulation and trading abuses

1) Manipulation (between future and underlying equity market)

- a) Frontrunning
- b) Tape-racing (exacerbated by absence of accurate reporting of last sales in the futures market)
- c) Mini-manipulations

no tape

- 2) Circumvention of rule 10b-6
- 3) Circumvention of tender offer rule
- 4) Insider trading abuses
- 5) "Gun jumping" abuses

carries - passing
independent outside
control.

C. Contract injects disorderliness in the securities markets.

1) Margin rules may be circumvented thus leading to excessive speculation

2) Unequal regulation may lead to diversion of capital:

- a) investor protection (see infra)
- b) differing tax treatment of futures and stocks.

D. Trading of equity portfolio contract outside the framework established under the federal securities laws is likely to frustrate the SEC's exercise of plenary authority in several respects.

- 1) Undermines Commission's development of comprehensive surveillance oversight system -- MOSS
- 2) Contract is likely to impede Commission efforts to promote national market system of all trading interest in equity securities -- e.g.;
 - a) Composite quotation system
 - b) Last sale reporting system
 - c) Market linkage and order routing systems (e.g. ITS and NASDAQ linkage)
 - d) Nationwide limit order protection
- 3) Will seriously complicate the SEC's task in adopting and enforcing rules which govern the equity markets and participants in those markets. For example:
 - a) Rules governing obligations of equity specialists and options market makers to provide continuity and depth in their respective markets must take into account an uncontrolled variable -- the existence of a "hidden" market which does not provide timely and accurate reporting of price and volume and which will divert buying and selling interest from the traditional securities markets.
 - b) Will require revision of rules designed to disclose trading interest in equity securities -- Sections 13(d), 13(f), 14(d), 16(a).
 - c) Will require revision of provisions under the Investment Company Act governing transactions of persons affiliated with investment companies -- Sections 17(a), 17(d), 17(j), Rule 17j-1.

IV. Approval of the Contract will have a Deleterious Affect on Investor Protection

A. Marketing

- 1) Futures are promoted as alternative "investment" medium, but persons trading futures are treated as "speculators" -- not investors -- under the commodities laws and board of trade rules.
- 2) Statistics in futures markets show that 80% of public customers lose.

B. Role of margin requirements to curb over-commitment by investors

- 1) Economic equivalence of security margin and commodity futures margin
- 2) CBOT has not set forth what margin will be

C. Suitability -

- 1) Securities & Options
- 2) No suitability requirement in CBOT submission

D. Disclosure and Advertising - no prospectus

E. Absence of SIPC counterpart

F. Training and supervision

- 1) entrance
- 2) testing
- 3) statutory disqualifications

V. Lack of Economic Purpose

- A. Legislative history demonstrate that no economic purpose is provided by such a contract which is not already provided in the listed options markets.
- B. May cause diversion of capital.
- C. No price discovery purpose, since equities trading takes into account future price expectations.
- D. Hedging function can be accomplished through a combination of diversification and options trading.

VI. Conclusion --

- A. Don't approve
- B. If CFTC does approve, SEC will assert jurisdiction, which may include adoption of rule prohibiting the trading of an equity portfolio future.