

M E M O R A N D U M

June 17, 1981

TO: Doug Scarff *Scarff*
FROM: Options Branch *RTC*
SUBJECT: Impact of the CBOT-SEC Litigation on the GNMA
Optional Forward Market

This is in response to the question you raised this morning on how the GNMA optional forward (or "standby") market would be affected if the Chicago Board of Trade ("CBOT") prevails in its current suit against the Commission concerning the issue of jurisdiction over exchange-traded options on GNMA's. It is our preliminary view that the outcome of the pending litigation should not, as a legal matter, alter the status under the Commodity Exchange Act ("CEA") of the GNMA standby market. Nevertheless, the heightened scrutiny of the market elicited by the suit, combined with success by the CBOT on the merits, may require the CFTC to focus more closely on the question of whether the current activities of dealers in the GNMA standby market is in violation of the commodity options ban. "

On its face, the CEA would appear to prohibit the trading of GNMA stand-bys. Section 4c(c) of the CEA and CFTC Regulation §32.3 specify that it is unlawful for any person to offer to enter into, enter into or confirm the execution of any commodity options transaction involving any commodity regulated under the CEA. 1/ On the basis of these provisions, the CFTC on numerous occasions has successfully brought actions to enjoin defendants from writing or purporting to write options on various commodities. The CFTC, however, has never to our knowledge sought to prohibit the trading of GNMA stand-bys.

In two cases involving foreign currency options, 2/ the defendants contended that, by virtue of the so-called "Treasury

1/ By virtue of being the subject of futures trading, GNMA's constitute "commodities" under Section 2(a)(1) of the CEA.

2/ See, CFTC and the State of Georgia v. Sterling Capital Company (S.D. Ga. 1981) CCH ¶21,169; CFTC v. American Board of Trade 473 F. Supp 1177 (S.D.N.Y. 1979).

exclusion" in Section 2(a)(1) of the CEA, 3/ the CFTC's jurisdiction with respect to foreign currency was limited to the regulation of futures trading and did not encompass trading of options. Both courts found, however, that the Treasury exclusion only prohibits the CFTC from regulating transactions in the cash market, and hence options trading on foreign currency fell within the proscription of the commodity options ban. Accordingly, this would not appear to be the basis for the CFTC's failure to act with respect to GNMA stand-bys.

The CFTC previously has expressed reluctance to exercise jurisdiction over the GNMA forward market because the contracts traded lacked the standardization necessary to raise it to the level of a futures market. Given the language of the statute and the various cases brought by the CFTC pursuant to the commodity options ban, however, neither standardization nor exchange trading appear to be relevant considerations in determining whether the CFTC has jurisdiction over commodity options. 4/

Being the CFTC apparently has not relied on the Treasury exclusion or the fact that the GNMA stand-by market is an over-the-counter market in deciding not to prohibit stand-by trading, it is unclear why the CFTC has refrained from asserting authority over the GNMA stand-by market. Whatever its rationale, it would not appear as a legal matter to be affected by the outcome of the CBOT-SEC litigation. As a practical matter, however, the attention focused on regulation of the GNMA market may make the CFTC's current position difficult to maintain.

3/ The Treasury exclusion states that "[n]othing in this Act shall be deemed to govern or in any way be applicable to transactions in foreign currency, security warrants, security rights, . . . government securities, . . . or mortgages and mortgage purchase commitments, unless such transactions involve the sale thereof for future delivery traded on a board of trade."

4/ The CFTC also concluded on the basis of legislative history that with respect to the GNMA forward market "regulation by the [CFTC] is unnecessary where there exists an informal market among institutional participants in transactions for futures delivery . . . only so long as it is supervised by those agencies having regulatory responsibility over those participants." CFTC Interpretative Letter No. 77-12 (Dealers in GNMA Certificates a Board of Trade (August 17, 1977) '75-'77 CCH ¶20,467). If the CFTC has adopted a similar rationale with respect to the GNMA stand-by market, relying on the Commission to police the markets under its antifraud authority, the CFTC position could be particularly awkward.