

ACTION MEMORANDUM

TO: The Commission

FROM: Office of the General Counsel *J. H. Hinkle, Jr. E. D. Roiter*

SUBJECT: Proposed Resolution of Jurisdictional Issues between the Commission and the Commodity Futures Trading Commission ("CFTC")

RECOMMENDATION: That the Commission endorse the proposed resolution negotiated by Chairman Shad and Chairman Johnson

NOVEL, UNIQUE OR COMPLEX ISSUES: (1) The appropriate relationship between the Commission and the CFTC.
(2) The appropriate regulatory structure for new financial instruments.

SUNSHINE ACT STATUS: Closed meeting pursuant to 5 U.S.C. 552b(c)(9)(B); 17 CFR 200.402(a)(9)(ii).

OTHER DIVISIONS OR OFFICES CONSULTED: Division of Market Regulation
Division of Investment Management

RESPONSIBLE STAFF PERSONS: Eric D. Roiter X22422
Anne E. Chafer X22426

As you know, the Chairmen of the Commission and the CFTC, after a series of meetings, have negotiated a tentative resolution of the jurisdictional issues facing the two agencies, an agreement which is subject to ratification by the members of each agency. To implement this agreement, the Commission and CFTC would jointly recommend to Congress that legislation (attached as Exhibit B) be enacted.

A. Changes From Prior Draft Statutory Language

The attached draft language contains three basic changes from the last version seen by the Commission. 1/ Originally,

1/ The Commissioners were first briefed on the resolution negotiated by the Chairmen in a memorandum from the Commission's Chairman dated October 23, 1981.

the Commission proposed that any approval by the CFTC of a future on a securities index be subject to the concurrence of the Commission. In the current agreement, that provision has been replaced with a provision requiring the CFTC to consult with the Commission, to afford the Commission an opportunity for an oral hearing in the event that the Commission objects to a proposal for a securities index future, and to give "appropriate weight" to the Commission's views. In addition, the Commission would explicitly be provided standing to challenge a CFTC order approving the trading of a securities index future over the Commission's objection. A second change in the draft legislation deletes a proposed amendment to the Investment Company Act which was designed to clarify that Act's applicability to commodity pools which, apart from trading in futures contracts, trade also in corporate or government securities or options thereon. 2/ A third change prohibits CFTC approval of futures contracts on registered equity and debt securities and municipal securities, but would permit CFTC approval of futures trading on any other security exempt from the registration requirements of the Securities Act and the Exchange Act. The earlier version had limited the CFTC's authority to futures on particular types of exempt securities -- namely, (1) U.S. government issued or guaranteed securities, (2) commercial paper with denominations greater than \$100,000, (3) certificates of deposit issued by federally regulated or insured banks. 3/

B. Basic Terms of the Agreement

In general, 4/ the draft legislation would resolve jurisdictional issues relating to (1) options on securities, security groups or indices, certificates of deposit, and foreign currency, (2) futures (and options on futures) on securities, and security groups or indices, and (3) the applicability of the securities laws to commodity pools. In addition, the

2/ Even without the clarification, the Commission will be able to assert the applicability of the Investment Company Act to commodity pools that are presently registered under that Act.

3/ The practical effect of this reaffirmation is substantially the same as the earlier version, with the exception of the amount and federal insurance requirements on commercial paper and certificates of deposit, respectively.

4/ A brief section-by-section analysis of the draft legislation is attached as Exhibit A.

legislation would make other changes to the securities and commodity laws to facilitate coordination between the two agencies.

With respect to options, the CFTC would not be able to authorize trading in options directly on any security or on a certificate of deposit (even assuming that a certificate of deposit is not a security for purposes of the Exchange Act), and the Commission's authority to approve such trading would be clarified. The Commission and the CFTC would be able to authorize national securities exchanges and boards of trade, respectively, to trade in options on foreign currency.

The CFTC would retain exclusive jurisdiction over the trading of futures on U.S. government issued or guaranteed securities, and options on such futures. Neither the Commission nor the CFTC would be authorized to permit the trading of futures (or options on futures) with respect to individual corporate equity or debt securities, other securities subject to the registration provisions of the Securities Act or the Exchange Act, or municipal securities. The CFTC could authorize trading of futures (and options on futures) with respect to a security group or index meeting certain conditions, after consultation with the Commission as discussed above.

The proposed legislation would also clarify the applicability of the Securities Act and the Exchange Act to commodity pools. Thus, pools engaged in an offering of their own securities would, absent the availability of an exemption, be subject to the registration and prospectus delivery requirements of the Securities Act, and would be subject to the periodic reporting requirements of the Exchange Act.

In addition to these provisions, the draft legislation would make a number of clarifying or technical changes to the securities and commodities laws. These include adding to the securities laws an explicit recognition that "puts" and "calls" are separate securities and authorizing the CFTC in the commodities laws to share information about trades with national securities exchanges.

C. Implementing the Agreement

Should the Commission determine to endorse this proposed resolution, there are a number of steps which will be required to mobilize support for the agreement. It appears advisable, prior to public announcement of the terms of the resolution, to inform certain interested parties of those terms and of the view of the two agencies that the proposed resolution will be in the public interest. Accordingly, the two Chairmen currently intend to meet with the Secretary of the Treasury.

Chairman Shad would also meet with securities industry representatives and with the heads of the Congressional committees with jurisdiction over securities matters and the Commission. (We expect the CFTC likewise to consult with its industry representatives and Congressional committees.) In addition, the Commission's General Counsel would meet with Michael Bradford, the General Counsel to the Board of Governors of the Federal Reserve System. Following these discussions, the two agencies plan to make the resolution public in a joint press release.

BRIEF SECTION-BY-SECTION ANALYSIS

COMMODITY EXCHANGE ACT

Section 2(a)(1)(A) The draft amendments would redesignate current Section 2(a)(1) as Section 2(a)(1)(A) and would make the changes necessary to avoid conflict with new Section 2(a)(1)(B) and to limit the scope of the so-called Treasury Amendment with respect to the trading of options on foreign currency conducted on a board of trade, so that the CFTC, as well as the SEC, may authorize their trading.

Section 2(a)(1)(B) This new section would provide that the CFTC has no jurisdiction to designate a board of trade as a contract market for an option on a security or on any group or index of securities. No person shall offer any futures contract (or option on such contract) on any securities subject to the registration requirements of the Securities Act or the Securities Exchange Act, any municipal security, or on any group or index of securities, except as provided. The CFTC may designate a board of trade as a contract market for futures (or options on futures) on a group or index of securities only if (1) settlement or delivery with respect to such futures or options on futures is effected by cash or a cash equivalent (including government securities); (2) trading in such contract is not readily susceptible to manipulation; and (3) the group or index of securities is a widely published measure of the securities market or a segment thereof, or is comparable to such a measure. The CFTC shall consult with the SEC prior to designating any board of trade as a contract market for a future (or option on a future) involving any group or index of securities. If the SEC objects, the CFTC shall afford the SEC an opportunity for an oral hearing and shall give appropriate weight to the SEC's views. Any order designating a board of trade as a market for such a contract over the objections of the SEC shall include findings that the standards are met, and the SEC shall have a right to judicial review.

Section 4m would be redesignated as Section 4m(1)

Section 4m(2) The draft amendment would clarify the applicability to commodity pools and commodity pool operators of the registration and reporting provisions of the Securities Act and the Exchange Act.

Section 8a The draft amendment would permit the CFTC to disclose information concerning futures market trades to self-regulatory organizations, provided that such information shall not be disclosed except in a self-regulatory action or proceeding.

SECURITIES ACT OF 1933

Section 2(1) The definition of "security" would be amended to include explicitly options on securities and certificates of deposit, as well as foreign currency options traded on a national securities exchange.

SECURITIES EXCHANGE ACT OF 1934

Section 3(a)(10) The definition of "security" would be amended to include explicitly options on securities and certificates of deposit, as well as foreign currency options traded on a national securities exchange.

Section 9(f) The SEC's plenary options authority would be applicable to options on exempted securities.

Section 9(g) The SEC may authorize a market for trading options on securities and on certificates of deposit and no other federal agency shall exercise such authority. This provision is necessary only to preclude concurrent CFTC jurisdiction over the trading of options on certificates of deposit, in the event that the Supreme Court in Marine Bank v. Weaver decides that CD's are not securities.

INVESTMENT COMPANY ACT OF 1940

Section 2(a) The definition of "security" would be amended to include explicitly options on securities and certificates of deposit, as well as foreign currency options traded on a national securities exchange.

INVESTMENT ADVISERS ACT OF 1940

Section 202(a) The definition of "security" would be amended to include explicitly options on securities and certificates of deposit, as well as foreign currency options traded on a national securities exchange.

COMMODITIES EXCHANGE ACT
[New Language Underlined]

Section 2(a)(1)(A)

* * * The word "commodity" shall mean * * * all services, rights, and interests in which contracts for future delivery are presently or in the future dealt in: Provided, That, subject to the provisions of subparagraph (a)(1)(B) hereunder, the Commission 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, and transactions subject to regulation by the Commission pursuant to section 19 of this Act; And provided further, 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 other regulatory authorities under the laws of the United States or of any State, or (ii) restrict the Securities and Exchange Commission and such other authorities from carrying out their duties and responsibilities in accordance with such laws. Nothing in this section shall supersede or limit the jurisdiction conferred on courts of the United States or any State. Nothing in this Act shall be

deemed to govern or in any way be applicable to transactions in foreign currency, security warrants, security rights, re-sales 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 or the trading of options on foreign currencies conducted on a board of trade.

Section 2(a)(1)(B) Notwithstanding any other provision of law --

(i) The Commission shall have no jurisdiction to designate a board of trade as a contract market for any transaction whereby any party to such transaction acquires any put, call or other option on a security (as defined in Section 2(1) of the Securities Act of 1933 or Section 3(a)(10) of the Securities Exchange Act of 1934 on the effective date of this Act), or on any group or index of such securities.

(ii) The Commission shall have exclusive jurisdiction with respect to, and may designate a board of trade as a contract market in, contracts (or options on such contracts) for future delivery involving a group or index of securities only if the Commission determines that the specific contract (or option on such contract) meets the following minimum requirements:

(a) Settlement of or delivery on such contract (or option on such contract) shall be effected in cash

or by a means other than the transfer or receipt of any underlying security, any security subject to the registration requirements of Section 5 of the Securities Act of 1933 or Section 12 of the Securities Exchange Act of 1934 on the effective date of this Act, or any municipal security, as defined in Section 3(a)(29) of the Securities Exchange Act of 1934 on the effective date of this Act;

(b) Trading shall not be readily susceptible to manipulation of the price of such contract (or option on such contract), or to use in the manipulation of the price of any underlying security, option on such security or group or index of securities.

(c) Such group or index of securities shall be a widely published measure of, and shall reflect, the market for all publicly traded equity or debt securities or a substantial segment thereof, or shall be comparable to such measure.

(iii) At least 45 days prior to the designation of any board of trade as a contract market in any contract (or option on such contract) for future delivery involving a group or index of securities, the Commission shall consult with the Securities and Exchange Commission with respect to such designation. If the Securities and Exchange Commission shall object to the designation of a board of trade as a contract market in such contract (or option on such contract) on the ground that any minimum requirement of subparagraph (ii) hereof is not met, the Commission shall afford the Securities

and Exchange Commission an opportunity for an oral hearing, to be transcribed, before the Commission prior to acting upon such designation, and shall give appropriate weight to the views of the Securities and Exchange Commission. In the event that such an oral hearing is held and the Securities and Exchange Commission fails to withdraw its objections, any order of the Commission designating a board of trade as a contract market for such contract (or option on such contract) shall set forth express findings that the minimum requirements of subparagraph (ii) hereof are met, and the Securities and Exchange Commission shall have the right of judicial review of such order in accordance with Section 6(b) of this Act.

(iv) No person shall offer to enter into, enter into, or confirm the execution of any contract (or option on such contract) for future delivery of: (1) any security subject to the registration requirements of Section 5 of the Securities Act of 1933 or Section 12 of the Securities Exchange Act of 1934 on the effective date of this Act; or (2) any municipal security as defined in Section 3(a)(29) of the Securities Exchange Act of 1934 on the effective date of this Act; or (3) any group or index of such securities except as provided in subparagraph (ii) hereof.

[Current Section 4m renumbered 4m(1)]

Section 4m(2).

Nothing in this Act shall affect the applicability of the Securities Act of 1933 or Securities Exchange Act of 1934 to a commodity pool operator, commodity pool, or their respective agents, or to any issuance of securities by or on behalf of a commodity pool operator or commodity pool, or to any offer, purchase or sale of such securities.

Section 8a. The Commission is authorized --

(6) to communicate to the proper committee or officer of any contract market, registered futures association, or self-regulatory organization as defined in Section 3(a)(26) of the Securities and Exchange Act of 1934, notwithstanding the provisions of Section 8 of this Act, the full facts concerning any transaction or market operation, including the names of parties thereto, which in the judgment of the Commission disrupts or tends to disrupt any market or is otherwise harmful or against the best interests of producers, [and] consumers or investors; Provided however, any information furnished by the Commission under this subsection shall not be disclosed by such contract market, registered futures association or self-regulatory organization except in any self-regulatory action or proceeding; and

SECURITIES ACT OF 1933

Section 2

(1) The term "security" means any note, stock, treasury stock, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit for a security, fractional undivided interest in oil, gas, or other mineral rights, any put, call, straddle, option, or privilege on any security or certificate of deposit or any put, call, straddle, option, or privilege entered into on a national securities exchange relating to foreign currency, or, in general, any interest or instrument commonly known as a "security," or any certificate of interest or participation in, temporary or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase any of the foregoing.

SECURITIES EXCHANGE ACT OF 1934

Section 3(a)

(10) The term "security means any note, stock, treasury stock, bond, debenture, certificate of interest or participation in any profit-sharing agreement or in any oil, gas, or other mineral royalty or lease, any collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit, for a security, any put, call, straddle, option, or privilege on any security or certificate of deposit or any put, call, straddle, option, or privilege entered into on a national securities exchange relating to foreign currency, or in general, any instrument commonly known as a "security"; or any certificate of interest or participation in, temporary or interim certificate for, receipt for, warrant or right to subscribe to or purchase any of the foregoing; but shall not include currency or any note, draft, bill of exchange, or banker's acceptance which has a maturity at the time of issuance of not exceeding nine months, exclusive of days of grace, or any renewal thereof the maturity of which is likewise limited.

SECURITIES EXCHANGE ACT OF 1934

Section 9

(f) The provisions of [this section] subsection (a) shall not apply to an exempted security.

(g) Notwithstanding any other provision of law, the Commission may authorize a market for the trading of any option on a security or on a certificate of deposit (but not an option on a contract for future delivery), and no other federal agency shall exercise such authority.

INVESTMENT COMPANY ACT OF 1940

Section 2(a)

(36) "Security" means any note, stock, treasury stock, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit for a security, fractional undivided interest in oil, gas, or other mineral rights, any put, call, straddle, option, or privilege on any security or certificate of deposit or any put, call, straddle, option, or privilege entered into on a national securities exchange relating to foreign currency, or, in general, any interest or instrument commonly known as a "security", certificate or interest or participation in, temporary or interim certificate for, receipt for, guarantee of, warrant or right to subscribe to or purchase any of the foregoing.

INVESTMENT ADVISERS ACT OF 1940

Section 202(a)

(18) "Security" means any note, stock, treasury stock, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit for a security, fractional undivided interest in oil, gas, or other mineral rights, any put, call, straddle, option, or privilege on any security or certificate of deposit or any put, call, straddle, option, or privilege entered into on a national securities exchange relating to foreign currency, or, in general, any interest or instrument commonly known as a "security", certificate or interest or participation in, temporary or interim certificate for, receipt for, guarantee of, warrant or right to subscribe to or purchase any of the foregoing.