

Commodity Futures
Trading Commission

Securities and Exchange
Commission

JOINT EXPLANATORY STATEMENT

As announced on December 7, 1981, the Commodity Futures Trading Commission ("CFTC") and the Securities and Exchange Commission ("SEC") have come to an agreement on a range of issues regarding their respective jurisdictions. In connection with this effort, the agencies have prepared draft legislation which, among other things, would clarify the statutes administered by the two agencies. The CFTC and the SEC are transmitting the draft legislative proposals to their respective Congressional committees, with this Statement, which explains a number of issues relating to the agreement. The two agencies urge that these statutory changes be enacted as promptly as possible.

The desirability of a resolution by the two agencies of the issues between them has become increasingly clear. The growing demand for new products related to securities or financial instruments, either as investments or as price hedging tools, has magnified the importance of removing the jurisdictional confusion that has hampered the development of the markets for such instruments. The confusion is a result essentially of amendments in 1974 to the Commodity Exchange Act (the "CEA") that (1) expanded the definition of "commodity" to embrace not only tangible goods but to

reach intangible rights and interests, (2) gave the CFTC "exclusive jurisdiction" over agreements and transactions "involving" futures trading in commodities, and (3) inserted in the CEA a qualified proviso to preserve the SEC's pre-existing authority over securities trading and the securities markets.

Summary

The two agencies have agreed that the SEC will regulate options on securities and on certificates of deposit (and on all groups or indices of securities or certificates of deposit) and the CFTC will regulate futures contracts on exempted securities (other than municipal securities) and on broad-based groups or indices of any securities, as well as options on any such futures contracts. No futures contracts (or options on futures contracts) on individual corporate and municipal securities will be permitted to trade. The SEC may also allow options on foreign currency to trade on national securities exchanges, while the CFTC will have jurisdiction to regulate the trading of options on foreign currency in the commodities markets. The attached legislative proposals would specifically codify the agreement of the two agencies by clarifying current law in certain areas.

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Options on securities

Since 1973, national securities exchanges have traded options on securities under the regulatory structure administered by the SEC. The proposals to amend the federal securities laws would relate to the SEC's authority

to regulate trading in options on securities. The SEC's authority over such trading on exempted securities has been challenged in the United States Court of Appeals for the Seventh Circuit. 1/ Thus, one proposal would clarify the definition of "security" in the federal securities laws to include explicitly any option on a security. 2/ In addition, options on foreign currency traded on a national securities exchange and options on certificates of deposit 3/ would be included within that definition.

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- 1/ Board of Trade of the City of Chicago v. Securities and Exchange Commission, et al., No. 81-1660 (7th Cir., petition for review filed April 24, 1981), (No. 81-2587 (7th Cir., petition for review filed October 5, 1981); and No. 82-1097 (7th Cir., petition for review filed January 21, 1982)).
- 2/ As a result, an option on an exempted security would expressly be a separate, non-exempted security. Accordingly, a person in the business of effecting transactions in such instruments would, absent an applicable exemption, be required, pursuant to Section 15 of the Securities Exchange Act of 1934 (the "Exchange Act"), to register with the SEC as a broker or dealer. To the extent, however, that such a requirement would impose an unnecessary burden on government securities dealers effecting transactions in options on government securities, the SEC has the authority administratively to provide an exemption from that requirement and currently intends to do so.
- 3/ Although the status of certificates of deposit as securities under the Securities Act of 1933 (the "Securities Act") and the Exchange Act is not free from doubt, certificates of deposit have consistently

(footnote continued)

Under the proposals, the SEC's authority over the trading of securities options also would be clarified by an amendment to Section 9(f) to establish specifically that the SEC's plenary options authority in Section 9(b) of the Exchange Act extends to options on exempted securities and by the addition of Section 9(g) which confirms the SEC's authority to regulate the trading of options on all securities and on certificates of deposit. The same legislative proposal would provide that only the SEC, and not the CFTC, has authority with respect to options directly on underlying securities and securities groups or indices.

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Under a series of proposed amendments to the federal commodity laws, the CEA would not apply to options on securities or securities aggregates, and the CFTC would not be permitted to designate a board of trade as a contract market for the trading of such instruments. Nevertheless,

3/ (footnote continued)

been considered "securities" for the purposes of the Investment Company Act of 1940. In order to emphasize that no change in current law is contemplated, the legislative language used in the two circumstances differs. Thus, for investment company purposes, the relevant portion of the definition of security would read "* * * option * * * on any security including a certificate of deposit," while the corresponding language proposed in the Securities and Exchange Act would read " * * * option * * * on any security, or certificate of deposit * * *."

the CFTC would have exclusive jurisdiction over all permissible futures contracts as well as options on those futures contracts, and would regulate options directly on foreign currencies traded in the commodity markets (but not on a national securities exchange).

Futures on individual corporate or municipal securities

Pending further review of appropriate regulatory systems for trading in such futures, the legislative proposal would foreclose the trading of futures (and options on futures) on individual corporate or municipal securities, or contracts based on the value of such a security. Nevertheless, the two agencies intend to study further the issues raised by such trading with a view toward a future recommendation to lift this restriction. This temporary foreclosure of trading does not apply to futures (or options on futures) on exempted securities, except municipal securities.

Futures on securities indices

The CFTC would be permitted under proposed amendments to the CEA to designate a board of trade as a contract market for contracts (or options on such contracts) of sale for future delivery of a securities group or index, but only if the contract (or option on such contract) meets certain specific minimum requirements set forth in the draft legislation as well as other requirements currently in the CEA.

With respect to a futures contract on a securities group or index (or option on such contract), settlement must be effected in cash or by means other than a security on which a futures contract could not be authorized. That is, such a contract could be settled by delivery of an exempted security, such as a security issued or guaranteed by the United States government, but could not be settled by the transfer or receipt of a corporate or municipal security.

Separate and apart from the present statutory requirement that any contract market have rules to prevent manipulation, the CFTC also would be required to find that trading in the contract under consideration would not be likely to produce manipulation in the futures markets or in related markets, i.e., those for any underlying security, option on such security, or option on a group or index including such securities. 4/

A securities group or index underlying a futures contract must be predominantly composed of the securities of unaffiliated issuers and, in addition, would be required to be a widely published measure of, and to reflect, the market for all publicly-traded equity or debt securities or a substantial segment of such market, or be comparable to such

4/ In order to address concerns relating to the general possibility of inter-market manipulation, the agencies have recommended the CEA be amended to authorize the CFTC to provide trade information to securities self-regulatory organizations and to registered futures associations, as well as to contract markets.

a measure. This standard is intended to provide adequate flexibility for the market to respond to the needs of participants, while assuring that only broad-based securities index futures contracts that are not conducive to manipulation could be authorized. 5/

In view of the SEC's strong regulatory concern with respect to the trading of futures on securities groups and indices, that agency would be provided a specific role in the process of CFTC designation of a contract market for the trading of such instruments. 6/ The CFTC would

5/ In practice, the two agencies believe that these standards will raise few substantial questions with respect to trading futures on established, widely-used indices containing a number of securities sufficient so that the indices will not be subject to manipulation. As one example, an index of most of the securities traded on a major national securities exchange would appear unlikely to present difficulties. Such indices also would seem more likely to be useful to the marketplace, since they would permit persons such as underwriters or portfolio managers to hedge the risk of overall market movements. However, it appears unlikely that indices not now in existence, based on bonds issued by a group of affiliated companies or on small industry groups, would meet such standards.

6/ Section 2(a)(8) of the CEA provides a procedure for CFTC solicitation of comments from the U.S. Department of the Treasury and the Board of Governors of the Federal Reserve System ("FRB") with respect to futures contracts involving securities issued or guaranteed by the U.S. government. As agencies concerned with the issuance of such securities and with monetary policy and debt management, the Treasury Department and the FRB clearly have an interest in the CFTC's designation of a market for futures on such instruments. Nevertheless, the SEC, as the regulator of trading markets in municipal and corporate securities, has an even more direct interest in the authorization of a related futures market. Thus, the involvement of the SEC in the designation process is intended to go beyond the relatively informal communications procedure established for the Treasury Department and the FRB.

be required to consult with the SEC with respect to designation of any board of trade as a contract market for any futures contract involving a securities group or index. Following a mandatory public comment period, the SEC would be provided with a specific time period during which it could object to the designation on the ground that any minimum requirement was not met. If the SEC objected, the CFTC would, if the SEC requested, afford it an opportunity, after the public comment period, for an oral hearing prior to action upon the designation. After the oral hearing, if the SEC continued to maintain its objections, the CFTC would be required to give appropriate weight to the SEC's views in deciding whether to authorize the contract. If, nonetheless, the CFTC designated a board of trade as a contract market for such a futures contract, 7/ the SEC would have the right to judicial review of such order, at which time the court would consider the CFTC's action and the SEC's views. In reviewing the CFTC action, the court would be required to determine, in accordance with the standards of Section 6(b) of the CEA, whether the agency action was supported by the weight of the evidence.

7/ If the CFTC refused to grant the application for designation and, pursuant to the CEA, afforded the board of trade an opportunity for a hearing on the record, the SEC would have the right to participate in that hearing as an interested party. Thus, the SEC would be permitted to present evidence and its views and to challenge the arguments advanced by the board of trade in support of its application.

Commodity pools

While the CFTC has adopted extensive regulations governing the activities of commodity pool operators and has exclusive jurisdiction with respect to "accounts * * * involving" futures, the SEC has taken the position that the activities of a commodity pool as a company, i.e., its formation, capital-raising, and continued corporate existence, are subject to the federal securities laws. The draft legislative language would make this result explicit by stating that nothing in the CEA affects the applicability of the Securities Act and the Exchange Act with respect to securities issued by commodity pools and transactions therein. Of course, the proposed language would not affect the exclusive jurisdiction granted by the CEA with respect to state regulation. Moreover, in appropriate circumstances, commodity pools and persons managing them may be subject to the Investment Advisers Act of 1940 and, if a pool conducts not only a commodities business but also acts as an investment company, the Investment Company Act of 1940.