



OFFICE OF THE  
GENERAL COUNSEL

## SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

March 26, 1982

The Honorable Richard Lugar  
Chairman, Subcommittee on Agricultural  
Research and General Legislation  
Senate Committee on Agriculture,  
Nutrition and Forestry  
United States Senate  
Washington, D.C. 20510

Dear Senator Lugar:

It has come to my attention that, on March 1, 1982, Robert Wilmouth, President of the Board of Trade of the City of Chicago, testified before the Subcommittee on Agricultural Research and General Legislation of the Senate Committee on Agriculture, Nutrition and Forestry concerning S. 2109. That bill would authorize appropriations for the Commodity Futures Trading Commission ("CFTC") through September 1986, and clarify the scope of the CFTC's authority with respect to options and futures contracts. During the course of his testimony, Mr. Wilmouth made certain inaccurate statements regarding the statutory responsibilities of the Securities and Exchange Commission. The purpose of this letter is to aid the Subcommittee by correcting any misunderstanding that may have arisen from Mr. Wilmouth's remarks.

S. 2109 and S. 2260, a related bill to amend the securities laws, would implement an agreement between the Commission and the CFTC reflecting what both agencies regard as an appropriate allocation of jurisdiction over options and futures on certain financial instruments. In general, that agreement provides that the SEC will regulate trading in options on securities, and the CFTC will regulate trading in futures on certain securities. <sup>1/</sup> In his testimony on S. 2109, Mr. Wilmouth indicated his opposition to the resolution reached by the two agencies. Specifically, he stated that the SEC's function "since its formation has been to regulate and

---

<sup>1/</sup> See Joint Press Releases of the Commission and the CFTC (December 7, 1981, and February 2, 1982).

preserve the capital-formation markets" and that "everything else the SEC does, from disclosure requirements to customer protection rules, is to protect the integrity of the capital markets of the United States." He then juxtaposed this characterization of the Commission's regulatory mandate with that of the CFTC, which he defined as the regulation of trading in "risk-shifting instruments." On the basis of this purported distinction, he concluded that since both options and futures serve a risk-shifting function, they both should be regulated by the CFTC.

Mr. Wilmouth's analysis, however, is based on a misperception of the scope of the Commission's authority. In particular, the Commission's mandate is not confined to the regulation of the capital-formation process, but rather encompasses a broad range of activities relating to securities, including the regulation of risk-shifting activities and instruments.

The Commission has responsibility to administer six statutes that, collectively, have as their purpose the regulation of the securities markets and participants in those markets. 2/ Certainly, Congress by means of the Securities Act, sought to regulate the capital raising process by codifying the concept of "full disclosure" in the issuance of securities and by protecting purchasers against fraud and misrepresentation. 3/ Under the Securities Act, an

---

2/ Securities Act of 1933, 15 U.S.C. 77a et seq. ("Securities Act"); the Securities Exchange Act of 1934, 15 U.S.C. 78a et seq. ("Exchange Act"); the Trust Indenture Act of 1939, 15 U.S.C. 77aaa et seq.; the Investment Advisers Act of 1940, 15 U.S.C. 80b et seq.; and the Investment Company Act of 1940, 15 U.S.C. 80a et seq.

3/ The Report of the Senate Committee on Banking and Currency stated that the objective of the Securities Act "is to prevent further exploitation of the public by the sale of unsound, fraudulent, and worthless securities through misrepresentation; to place adequate and true information before the investor; to protect honest enterprise, seeking capital by honest presentation, against the competition afforded by dishonest securities offered to the public through crooked promotion; to restore the confidence of the prospective investor in his ability to select sound securities; to bring into productive channels of industry and development capital which has grown timid to the point of hoarding; and to aid in providing employment and restoring buying and consuming power." Senate Report No. 47 to Accompany S. 875, 73d Cong., 1st Sess. 1 (1933).

issuer engaged in the public sale of securities (other than exempted securities) is required to register such securities with the Commission and make available to prospective purchasers a written prospectus containing, among other things, financial and other information relating to the issuer and its business, and a description of the plan and purpose of the distribution.

Regulating capital formation which occurs through the issuance of securities, however, is only one aspect of the Commission's comprehensive regulation of the securities markets. While the Securities Act is concerned primarily with issuance and distribution, the Securities Exchange Act focuses principally on the trading of securities in the secondary market. That statute is designed to provide that persons buying and selling securities will have information enabling them to make informed investment decisions; to prevent and provide remedies for fraud and manipulation occurring in connection with securities trading; to provide for fair and orderly securities markets; and to regulate the extension of credit in connection with securities trading. 4/

---

4/ As stated in Section 2 of the Exchange Act, "transactions in securities as commonly conducted upon securities exchanges and over-the-counter markets are affected with a national public interest which make it necessary to provide for regulation and control of such transactions and of practices and matters related thereto, including transactions by officers, directors, and principal security holders, to require appropriate reports, to remove impediments to and perfect the mechanisms of a national market system for securities and a national system for clearance and settlement of securities transactions and the safeguarding of securities and funds related thereto, and to impose requirements necessary to make such regulation and control reasonably complete and effective, in order to protect interstate commerce, the national credit, the Federal taxing power, to protect and make more effective the national banking system and the Federal Reserve System, and to insure the maintenance of fair and honest markets in such transactions." 15 U.S.C. 78b.

Effective regulation in these areas clearly has a salutary effect on the capital formation process since it assures that an investor acquiring securities in an initial public offering can resell them in an honest and competitive market. The Congress, however, did not pass the Exchange Act solely to achieve this narrow goal.

Under the Exchange Act, registration and reporting requirements, combined with the regulation of proxy solicitations and tender offers, not only provide information that facilitates secondary trading, but also promote fair dealings between a corporation and its shareholders. 5/ The regulation of national securities exchanges not only prevents improper trading activities, but also affirmatively promotes fair and orderly markets by, among other things, limiting marketmaker trading on exchange floors in order to reduce conflict with public orders. 6/ The regulation of broker-dealers pursuant to the Exchange Act is designed to prevent fraudulent activities, safeguard financial responsibility, ensure technical competence, and, particularly through self-regulatory organizations, promote "just and equitable principles of trade." 7/ Margin requirements, established by

---

5/ See Sections 13 and 14 of the Exchange Act, 15 U.S.C. 78m and 78n.

6/ See Section 11 of the Exchange Act, 15 U.S.C. 78k, and the rules thereunder. In this regard, the Report of the House Committee on Interstate and Foreign Commerce accompanying a bill which was a predecessor of the Exchange Act, stated that "[t]he bill proceeds on the theory that the exchanges are public institutions which the public is invited to use for the purchase and sale of securities listed thereon, and are not private clubs to be conducted only in accordance with the interest of their members." Report to Accompany H.R. 9323, H.R. Rep. No. 1383, 73d. Cong., 2d Sess. 15 (1934).

7/ For example, Congress in amending the Exchange Act to provide for national securities associations envisioned that self-regulatory organizations of this type, among other things, would "cope with those methods of doing business which, while technically outside the area of definite illegality, are nevertheless unfair both to customer and to decent competitor, and are seriously damaging to the mechanism of a fair and open market." Report of the House Committee on Interstate and Foreign Commerce to Accompany S. 3255, H.R. Rep. No. 2307, 75th Cong., 3rd Sess. 4 (1938).

the Board of Governors of the Federal Reserve System and enforced by the Commission under the Exchange Act, protect investors against the risks associated with trading equities on thin margins, protect the securities markets from possible disruption caused by excessive speculation on credit, and also serve as an instrument of monetary policy. 8/ These features of regulation under the Exchange Act clearly demonstrate that the SEC's mandate goes far beyond the capital raising process.

Moreover, the Commission's authority over the securities markets specifically encompasses the regulation of a number of financial instruments and strategies which involve the transfer from one party to another of the risk of price fluctuations. One obvious example of Commission authority over risk-shifting instruments is its regulation of options. Options allow hedging against an adverse price movement in the underlying security, while at the same time retaining the opportunity to profit from a favorable price movement. A variety of spreads, straddles and other options trading strategies permit options market participants to further refine the risks they wish to bear.

The Commission's authority with respect to risk-shifting is not confined to options. Stock warrants, convertible debentures, and repurchase agreements are examples of other securities instruments that are subject to the Commission's oversight. Short sales are an example of a risk-shifting trading practice which is subject to specific Commission regulation. 9/ In fact, the Commission's regulation of secondary trading in securities is an exercise of jurisdiction over risk-shifting. A transaction in the secondary market does not expand or contract the amount of capital invested in securities. Rather, the economic risks and opportunities associated with ownership merely are shifted from the seller to the buyer.

---

8/ According to the House Committee on Interstate and Foreign Commerce, the margin provisions of the Exchange Act were intended in part "to give a Government credit agency an effective method of reducing the aggregate amount of the nation's credit resources which can be directed by speculation into the stock market and out of more desirable uses of commerce and industry." H.R. Rep. No. 1383, 73d Cong., 2d Sess. 8 (1934).

9/ Sections 10(a) and 16(c) of the Exchange Act, 15 U.S.C. 78j(a).and 78p(c).

The Honorable Richard Lugar  
Page six

The securities laws have never drawn a distinction between risk-shifting or trading, on the one hand, and capital formation or investment on the other. Rather, they have recognized that sound secondary markets and special risk-shifting instruments and strategies, such as options, facilitate capital formation by assuring investors of fairness and flexibility in subsequent transactions. Thus, the asserted distinction between capital raising and risk-shifting simply is not one which has been employed in allocating responsibilities to the Commission.

Similarly, in reaching their accord, the Commission and the CFTC sought to allocate jurisdiction over various financial instruments in a manner conforming to the historical developments of the regulatory structure to date. The agencies considered the full range of their respective regulatory responsibilities and arrived at a solution which they believe accommodates the legitimate interests of all parties. As a result, the agreement recognizes the SEC's authority over securities, including risk-shifting aspects of the securities markets, and the CFTC's authority over futures and the markets in which they are traded.

Sincerely,

*Edward F. Greene*   
Edward F. Greene  
General Counsel

cc: Robert Wilmouth  
Members of the Subcommittee