

The Chicago Board
Options
Exchange

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The Honorable Alfonse D'Amato
Chairman, Subcommittee on Securities
Committee on Banking, Housing and Urban Affairs
432 Russell Senate Office Building
Washington, DC 20510

Dear Senator D'Amato:

The Chicago Board Options Exchange, Incorporated ("CBOE") is pleased to submit this letter in support of S.2260 which will clarify the authority of the Securities and Exchange Commission ("SEC") over put and call options on registered and exempt securities, certificates of deposit and foreign currencies. S.2260 has certain complementary provisions in S.2109, the Futures Trading Act of 1982, and those provisions already have been endorsed by the appropriate Subcommittee Senate Agriculture Committee. However, there are a number of controversial features in S.2109, entirely unrelated to S.2260, which may significantly delay the passage of S.2109. In view of regulatory uncertainties created by a recent court decision, discussed below, we think S.2260 should be uncoupled from the proposed Futures Trading Act and passed as expeditiously as possible. Further, until S.2260 is adopted the securities industry cannot go forward with the introduction of a number of innovative financial products. To not adopt S.2260 promptly would be fundamentally unfair to the securities industry. The Commodity Futures Trading Commission ("CFTC") has already begun to implement provisions contained in the proposed Futures Trading Act, as evidenced by its recent approval of a new futures contract on a stock index. Yet, until S.2260 is passed, the securities industry will be stymied in its efforts to bring new products to market. Prompt passage of S.2260 is necessary to correct this fundamental inequity.

CBOE is the Nation's largest options exchange. It is registered with the SEC as a national securities exchange, and, since its inception in 1973, has been subject to the regulatory jurisdiction of the SEC. It is the only exchange that limits its activities to providing a market in securities options.

S.2260 and corresponding provisions in the proposed Futures Trading Act are needed because distinctions that previously existed between the futures industry and the securities industry are no longer clear. This lack of clarity

has been the cause of a lengthy dispute between the SEC and the CFTC over which agency should regulate particular kinds of new financial products.

CBOE is probably the organization that has been hit the hardest by the uncertainties respecting the SEC's jurisdiction, and this is particularly so in connection with efforts to develop new markets in options on GNMA securities and Treasury securities. Over five years ago it came to CBOE's attention that there was a need in the United States for a regulated, reliable, hedging vehicle that would permit persons involved in housing construction and finance to hedge against changes in increasingly volatile interest rates. With the enthusiastic support and encouragement of institutions involved in home building and mortgage banking, CBOE spent over four years and over \$1,000,000 developing a GNMA options market that would fill this need. In developing this new product CBOE relied heavily on years of experience in the operation and regulation of its existing stock options market. Reflecting our past experience, which included the information gathered in the SEC's extensive 1978 Special Study of the Options Markets, CBOE developed a GNMA options product that is based on the same general approach to market regulation and investor protection, including margin requirements, risk disclosure and sales practice regulation, that has proved so successful in the regulation of the stock options market.

Finally, after all of this effort and expense, the necessary regulatory approvals of the SEC were obtained. CBOE and the member firm community geared up to commence trading in the Fall of 1981. The necessary people to run the markets were hired; the participants in the securities industry were trained; the needed communications systems and other equipment were purchased and installed; the prospectus was written and registered; and the computers were programmed. Yet, the first GNMA option remains to be traded.

Shortly after the SEC approved the trading of GNMA options, the Board of Trade of the City of Chicago petitioned the United States Court of Appeals for the Seventh Circuit to set aside the order of the SEC. The Board of Trade is a futures Exchange under the jurisdiction of the CFTC, and it currently trades futures contracts in GNMA's. It apparently was concerned that CBOE's new options market might compete with the existing futures market or with a proposed market for options on these futures. The Board of Trade, later joined by the CFTC, took the position that, GNMA's became a commodity under the Commodity Exchange Act ("CEA") when the Board of Trade began trading GNMA futures on them in 1975, that the CFTC thereby acquired exclusive or concurrent jurisdiction over GNMA options, and that the SEC did not have any juris-

diction under the securities laws over options traded on a national securities exchange, even though GNMA's were themselves securities. The SEC, the CBOE and the other securities industry participants argued that the SEC has jurisdiction over the trading of options on securities on a national securities exchange under the securities laws and that such jurisdiction is not displaced by the fact that the underlying security also happens to be the subject of futures trading.

On March 24, 1982 the Court announced a 2-1 decision setting aside the SEC order. Although the majority recognized that the statutes "are complex enough to admit different opinions of their proper construction," it held that (1) although GNMA's are securities, they also became commodities under the CEA when the Board of Trade began trading futures on them, (2) the CFTC has exclusive jurisdiction (and the SEC none) over options on GNMA's securities because the options "involve" the futures contracts, (3) exchange-traded options on securities (such as those traded on CBOE, the American Stock Exchange, the Philadelphia Stock Exchange and the Pacific Stock Exchange) are not themselves securities under the securities laws, and (4) the SEC has no authority under the securities laws to regulate options on exempted securities.

The logic of the Court's decision will lead to continual expansion of CFTC jurisdiction and concomitant reduction in SEC jurisdiction whenever futures trading in a security commences. As the majority opinion stated, under the Commodity Exchange Act "literally anything... could become a 'commodity' and thereby subject to CFTC regulation simply by its futures being traded on some exchange." (emphasis added) The majority thus reads out of the Commodity Exchange Act any distinction between securities and agricultural products. The court did this regardless of the fact that ever since the enactment of the Securities Exchange Act in 1934, Congress has assigned to the SEC regulatory authority over securities and options on securities, and without any regard to the fact that the legislative history of the Commodity Exchange Act speaks to Congressional intent to save for the SEC its traditional jurisdiction. Indeed, the majority states that exempted securities are "closer in nature to traditional commodities such as corn or pork bellies, than to traditional corporate stocks."

Under this decision, the SEC and the Federal Reserve Board will lose jurisdiction over large areas for which they now exercise regulatory authority. If options are not securities, then CBOE is not a national securities exchange, and it is not at all clear what role the SEC may play with regard to public customer protection. Further, because the Federal

Reserve Board has authority to impose margins only upon securities, under this decision options will not be subject to federal margin requirements. It seems to us that the question of whether margins may be imposed on options is one that should be addressed directly by the Federal Reserve Board or by the Congress, and not decided indirectly by a court which appears to have not even considered the issue.

It also should be noted that it is not only the SEC's jurisdiction that is affected when the CFTC gains exclusive jurisdiction. State securities commissions also lose their jurisdiction. Under the Securities Exchange Act of 1934, the States play a significant role in all aspects of securities regulation. Under the Commodity Exchange Act, however, the grant of exclusive jurisdiction to the CFTC results in preemption of the basic police power of States to protect their citizens from fraudulent activity.

Much of the uncertainty created by the case will be corrected through adoption of S.2260, which contains the required securities laws amendments. S.2260 will amend the definition of security in the statutes administered by the SEC (Securities Act of 1933, Securities Exchange Act of 1934, Investment Company Act of 1940 and Investment Advisers Act of 1940) to assure that options on securities, on certificates of deposit, and on foreign currencies come under SEC jurisdiction. Section 9 of the Securities Exchange Act of 1934 will also be amended to provide that notwithstanding any other provisions of law (including the Commodities Exchange Act) the SEC will have the authority over options on securities and on certificates of deposit.

It seems to us that in view of the many uncertainties created by the majority in the Seventh Circuit decision, it would be inappropriate to delay passage of S.2260 merely in order to enact it in tandem with S. 2109, the Futures Trading Act of 1982. S.2109 is a lengthy bill with many controversial issues, such as the reach of the CFTC's enforcement processes and corresponding role of the States, registration requirements for professionals in the futures industry, procedures for processing exchange rules, streamlining reparations procedures, margin-setting authority, private rights of action, judicial review of CFTC emergency orders, agricultural options, creation of a futures self-regulatory organization and a user fee on exchange transactions.

As you know, the appropriate Subcommittee of the Senate Agriculture Committee recently approved the proposed Futures Trading Act of 1982 without the proposed provision for a user fee. Yet, the Director of the Office of Management and Budget recently has been reported as being critical of this

position, and announced that it is the intention of the administration to veto that bill unless it contains a user fee provision. It seems to us that these diametrically opposite positions on a critical issue suggest that there will be significant delay in enacting the bill. Indeed, it is not inconceivable that the CFTC's charter will be temporarily extended while Congress, the administration and the futures industry come to a consensus on these issues. S.2260 thus might be held up for reasons that are entirely unrelated to its purposes.

The resulting delay would cause serious economic losses to the securities industry. As noted above, CBOE has incurred significant costs developing options on exempt securities. The entire securities industry also has incurred significant costs preparing to trade these options. We are not able to quantify those costs, but it is a significant multiple of the several million dollars expended by CBOE. At this time, those resources, such as personnel and computers, are on "hold", waiting merely for the legislation embodied in S.2260 to be enacted. For the securities industry, keeping these resources on "hold" is expensive and inefficient, and is particularly bothersome in view of the fact that S.2260 could be enacted independently of the Futures Trading Act of 1982. That would allow these resources to be put to use immediately.

For the reasons stated above, CBOE urges prompt enactment of S.2260.

Sincerely,

A handwritten signature in dark ink, appearing to read 'Walter E. Auch', is written over the typed name.

Walter E. Auch
Chairman and Chief
Executive Officer