

ELI WHITNEY DEBEVOISE
FRANCIS T. P. PLIMPTON
OSCAR M. RUEBHAUSEN
WILLIAM EVERDELL
D. BRET CARLSON
GEORGE N. LINDSAY
STANLEY R. RESOR
JAMES B. WELLES, JR.
ROSWELL B. PERKINS
ROBERT B. VON MEHREN
HAROLD H. HEALY, JR.
JOSEPH BARBASH
CHESTER BILLINGS, JR.
MICHAEL HARPER GOFF
WILLIAM B. MATTESON
BARRY R. BRYAN
RICHARD D. KAHN
ASA POUNTREE
GEORGE B. ADAMS, JR.
ROBERT J. GENIESSE
ANDREW C. HARTZELL, JR.
PHILIP S. WINTERER
STEPHEN BENJAMIN
LOUIS BEGLEY
GUY PASCHAL
DAVID V. SMALLEY
CECIL WRAY, JR.
JAMES C. GOODALE
JOHN F. JOHNSTON 2ND
ROBERT L. KING

STEPHEN J. FRIEDMAN
JOHN D. NILES
MEREDITH M. BROWN
BRUCE D. HAIMS
STANDISH FORDE MEDINA, JR.
EDWARD A. PERELL
THEODORE A. KURZ
HUGH ROWLAND, JR.
ROBERT J. GIBBONS
MICHAEL E. PATTERSON
BARBARA PAUL ROBINSON
JONATHAN A. SMALL
VINCENT M. SMITH
PAUL H. WILSON, JR.
WOLCOTT B. DUNHAM, JR.
JEFFREY S. WOOD
STEVEN M. ALDEN
JOHN H. HALL
JOHN G. KOELTL
RALPH C. FERRARA
JAMES A. KIERNAN III
HANS BERTRAM-NOTHMAGEL
MARTIN FREDERIC EVANS
STEVEN R. GROSS
ROGER E. PODESTA
MARIO L. BAEZA
WOODROW CAMPBELL, JR.
GLEN LEWY
MARCUS H. STROCK

DEBEVOISE & PLIMPTON

299 PARK AVENUE · NEW YORK, N.Y. 10171

(212) 752-6400

April 19, 1982

RECEIVED

APR 21 1982

OFFICE OF GENERAL COUNSEL

CABLE DEBSTEVE NEW YORK
INTERNATIONAL TELEX 234400
DOMESTIC TELEX 12-6607
RAPIFAX (212) 832-1475
XEROX TELECOPIER (212) 750-9276

WASHINGTON OFFICE
1777 F STREET, N.W.
WASHINGTON, D.C. 20006
TELEPHONE (202) 289-0100
RAPIFAX (202) 289-0482

ROBERT J. GENIESSE
RALPH C. FERRARA
MARTIN FREDERIC EVANS

EUROPEAN OFFICE
5, PLACE DU PALAIS BOURBON
75007 PARIS
TELEPHONE 555-06-66
TELEX DEBSTEVE 250602F

MICHAEL E. PATTERSON
DOMINIQUE BLANCO

*ADMITTED IN NEW YORK ONLY

*ADMITTED IN DISTRICT OF COLUMBIA ONLY

Edward F. Greene, General Counsel
Securities and Exchange Commission
500 North Capitol Street, N.W.
Washington, D.C. 20549

Dear Ed:

I enclose for your information a copy of a letter that I have sent to relevant Committee Chairmen on the Hill concerning the legislative compromise the CFTC and the SEC have recommended to their respective oversight Committees to resolve their jurisdictional differences. As you will see, I could not resist commenting on some of the substantive regulatory concerns that I have concerning the trading of comparable financial products in separately regulated market places operating under differing legal schemes.

I would appreciate any comments or reactions that you may have.

Sincerely,


Ralph C. Ferrara

DEBEVOISE & PLIMPTON

299 PARK AVENUE • NEW YORK, N.Y. 10171

(212) 752-6400

April 16, 1982

CABLE DEBSTEVE NEW YORK
INTERNATIONAL TELEX 234400
DOMESTIC TELEX 12-6607
RAPFAX (212) 832-1475
XEROX TELECOPIER (212) 750-9276

WASHINGTON OFFICE
1777 F STREET, N.W.
WASHINGTON, D.C. 20006
TELEPHONE (202) 289-0100
RAPFAX (202) 289-0482

ROBERT J. GENIESSE
RALPH C. FERRARA
MARTIN FREDERIC EVANS

EUROPEAN OFFICE
5, PLACE DU PALAIS ROYAL
75007 PARIS
TELEPHONE 555-06-66
TELEX DEBSTEVE 250602F

MICHAEL E. PATTERSON
DOMINIQUE BLANCO

* ADMITTED IN NEW YORK ONLY

LI WHITNEY DEBEVOISE
RANCIST P. PLIMPTON
SCAR M. RUEBHAUSEN
WILLIAM EVERDELL
BRET CARLSON
EORGEN LINDSAY
TANLEY R. RESOR
AMES B. WELLES, JR.
OSWELL B. PERKINS
OBERT B. VON MEHREN
AROLD H. HEALY, JR.
JOSEPH BARBASH
HESTER BILLINGS, JR.
MICHAEL HARPER GOFF
ILLIAM B. MATTESON
ARRY R. BRYAN
RICHARD D. KAHN
ASA ROUNTREE
GEORGE B. ADAMS, JR.
ROBERT J. GENIESSE
ANDREW C. HARTZELL, JR.
PHILIP S. WINTERER
STEPHEN BENJAMIN
LOUIS BEGLEY
GUY PASCHAL
DAVID V. SMALLEY
CECIL WRAY, JR.
JAMES C. GOODALE
JOHN F. JOHNSTON 2ND
ROBERT L. KING

STEPHEN J. FRIEDMAN
JOHN D. NILES
MEREDITH M. BROWN
BRUCE D. HAMS
STANDISH FORDE MEDINA, JR.
EDWARD A. PERELL
THEODORE A. KURZ
HUGH ROWLAND, JR.
ROBERT J. GIBBONS
MICHAEL E. PATTERSON
BARBARA PAUL ROBINSON
JONATHAN A. SMALL
VINCENT M. SMITH
PAUL H. WILSON, JR.
WOLCOTT B. DUNHAM, JR.
JEFFREYS WOOD
STEVEN M. ALDEN
JOHN H. MALL
JOHN G. KOELT
RALPH C. FERRARA
JAMES A. KIERNAN III
HANS BERTRAM NOTHNAGEL
MARTIN FREDERIC EVANS
STEVEN R. GROSS
ROGER E. PODESTA
MARIO L. BAEZA
WOODROW W. CAMPBELL, JR.
GLEN LEWY
MARCUS H. STROCK

* ADMITTED IN DISTRICT OF COLUMBIA ONLY

The Honorable E. de la Garza, Chairman
Committee on Agriculture
United States House of Representatives
1434 Longworth House Office Building
Washington, D.C. 20515

Dear Mr. Chairman:

As one who has witnessed firsthand the long and arduous process toward reconciliation of the jurisdictional mandates of the Commodities Futures Trading Commission and the Securities and Exchange Commission, I would like to take this opportunity to share some of my thoughts on the re-authorization legislation now under consideration.

The CFTC and the SEC, under the leadership of Chairman Johnson and Chairman Shad respectively, have reached an agreement which, if implemented, will serve the markets, market participants, and the agencies themselves exceedingly well. For the first time since creation of the CFTC in 1974, the statutory jurisdiction of each agency is clearly delineated. Within this framework, the federal government may now play a more effective part in ensuring the orderly growth of "new product" options and futures. For several years, the energies of the SEC and CFTC have, in my view, been misspent in extensive legal arguments over the precise bounds of the CFTC's exclusive jurisdiction.

As you may recall, the dispute first arose in 1975, when the newly authorized CFTC was considering proposals from various boards of trade for designation of futures contracts on Treasury bills and mortgage-backed certificates guaranteed by the Government National Mortgage

April 16, 1982

Association. Disagreement between the two agencies again arose during the CFTC's reauthorization hearings in 1978, when the SEC asked Congress to transfer to it jurisdiction over futures trading on any security. Shortly thereafter, the SEC took issue with various proposals by boards of trade seeking CFTC approval of futures trading on stock indexes.

In particular, the SEC in August of 1978 transmitted a lengthy submission to the CFTC criticising the proposal by the Kansas City Board of Trade for designation of a futures contract on the Dow Jones 30 industrial average, expressing strong reservations over the economic purpose of the proposed contract, the risks to investor protection, the potentially adverse impact on the underlying equity markets, and the effects of unequal regulation. Shortly thereafter, in October 1978, I testified on behalf of the SEC before the CFTC during its consideration of the KCBT futures contract proposal, focusing upon the surveillance and other regulatory problems engendered by the trading of derivative instruments such as stock index contracts. The SEC reiterated its opposition to stock index futures on both public policy and jurisdictional grounds in a letter to the CFTC in February of 1980.

Of course, as I am sure you are aware, the most recent dispute between the SEC and the CFTC arose from the SEC's approval by the CBOE of a rule change authorizing the trading of options on GNMA securities. That approval has been set aside by a three-judge panel of the U.S. Court of Appeals for the Seventh Circuit in Chicago Board of Trade v. Securities and Exchange Commission, No. 81-1660 (7th Cir., March 24, 1982), and the SEC has now petitioned for a rehearing.

At the time they were challenging the bounds of each other's jurisdiction in the Seventh Circuit, however, the SEC and CFTC were engaged in negotiations to reconcile their respective jurisdictions through legislation. It would indeed be tragic if, given the long history of disagreement between the two agencies, a legislative settlement of the jurisdictional dispute were to be undone by the Seventh Circuit's recent decision. Indeed, the two agencies entered into their negotiations with the common understanding that they would continue to support a legislative resolution regardless of the outcome of pending litigation.

April 16, 1982

The legislative compromise struck, in my view, is based upon sound policy, clear logic, and workable legal standards. The CFTC's role as the sole regulator of futures trading is preserved. Under the agreement the CFTC's authority to approve futures trading on all exempt securities is ratified, and the CFTC is expressly authorized to approve futures contracts on broad-based securities indexes upon determining that the index will not facilitate or engender manipulation of the underlying equity market or options market. The CFTC is permitted to oversee the development of options on financial futures as well. The SEC, on the other hand, is authorized to continue in its traditional role as the sole federal regulator of the securities options markets. The legislative proposal would clarify the SEC's authority over options trading on all forms of securities and securities indexes, whether or not the underlying instrument is a corporate security or a security issued or guaranteed by a governmental or quasi-governmental entity. For the time being, both agencies have agreed that futures trading on individual corporate securities or small groups of those securities should not commence, but rather should await further study.

For the near term, the agreement provides a bright line standard for market participants and clears the path for innovation and competition. A number of commentators have urged that a merger of the two agencies is the best long-term solution. In the past, those who have supported a separate agency for the regulation of futures trading have drawn a distinction between capital formation (which all concede is the proper province of the SEC) and hedging and price discovery (which is the economic *raison d'etre* of futures trading). With the development of options and futures on equity indices, however, this distinction has blurred. Indeed, the very justification for securities index futures is that the risk shifting function served by the derivative instrument will assist the capital formation process by permitting investors to hedge their portfolio risks.

I believe that Congress should reserve this question of merger for another day -- after these new instruments have been adequately tested in the market. In this regard, a special study of the futures market and its impact on the capital formation process, called for in an amendment

recently sponsored by Rep. Glickman and adopted by the House Agriculture Subcommittee on Conservation, Credit and Rural Development, would be particularly useful. I suggest, however, that this type of study be undertaken by an independent commission or academic institution, rather than by the CFTC, SEC and other agencies. Although the CFTC, SEC and others may be asked to contribute to the study, the macro-economic questions that need to be addressed are not, I think, within the specialized areas of expertise of the regulatory agencies. This approach is consistent with the proposal of SEC Chairman Shad for a similar study of the regulatory framework that now separates the securities and banking industries.

A resolution of jurisdictional issues, paving the way for increasingly greater overlap of the futures and securities markets, makes even more important that the regulatory schemes administered by the two agencies be roughly comparable in protecting investors and in ensuring the integrity of the markets. In this regard, I believe that Congress should insist that basic investor safeguards that have been employed in the securities markets have their analogues in the commodity markets -- at least where the futures contract is based on an underlying financial instrument and not an agricultural product. Perhaps the most important ingredient to ensure investor protection and to protect the market from excessive speculation is to provide for federal authority to set margin requirements on commodity futures comparable to requirements set on securities options.

I am aware that legal distinctions may be made between commodities margin and securities margin. But as an economic matter, both types of margin determine the amount of leverage available to investors and speculators. In exercising its authority under Section 7 of the Securities Exchange Act of 1934, the Federal Reserve Board has required an investor who writes an option on an equity security, if uncovered, to deposit at least 30% of the value of the underlying stock plus the amount the option is in the money. In contrast, the boards of trade in exercising their unreviewable authority to set margin in futures contracts have imposed margin levels at much lower than 30% -- indeed lower than 10%. I understand that the Kansas City Board of Trade, to forestall the assertion by the Federal Reserve Board of authority over its index futures contract, agreed to increase the margin requirement for that futures con-

April 16, 1982

tract. While that outcome is perhaps a salutary one, it is not clear that this process will result in comparable levels of margin for financial instruments that may be traded in other markets. More importantly, the setting of margin is not, in my view, something to be negotiated between the Federal Government and the sponsoring market. Rather the Federal Government -- whether through the Federal Reserve Board or the CFTC -- should be clearly authorized to set a minimal level of margin. The sponsoring market is free to increase the margin required, but cannot adopt a margin requirement lower than that set by the government.

It is difficult to overstate the danger to investor protection and market stability that is posed by a highly leveraged instrument such as a future or an option on an equity index. While I was General Counsel at the SEC, the staff studied the effect that a small swing in the value of a stock index futures contract would have on an investment. Analyzing the Value Line proposal of the Kansas City Board of Trade, we calculated that a 4% change in the average would wipe out 50% of the initial margin of \$4,000 then required to purchase a \$50,000 contract. A cumulative drop of just 8% in the average would result in a total loss of initial margin. If the investor had adequate means to meet additional margin calls, he might benefit when and if the market were to reverse fields. But, as a practical matter, the initial margin may well constitute the total financial commitment which an investor is able or willing to make.

The risks to investor protection are compounded if the broker or futures commission merchant is not required to adhere to a suitability standard in making recommendations to his customers. The suitability doctrine applicable to securities trading requires generally that a broker-dealer recommend to his customer only those securities that he reasonably believes are suitable in light of the customer's financial position and investment goals. To discharge his responsibility the salesperson must make a diligent inquiry into the customer's investment objectives and financial needs. The securities options exchanges have for some time imposed more stringent suitability requirements, requiring that the salesperson have a reasonable basis to believe that the investor is knowledgeable and experienced in financial matters and is capable of evaluating the risks of options transactions. It should be emphasized that a suitability

April 16, 1982

rule is no impediment to the honest securities or commodities professional, and does not transform the broker into a guarantor against losses. The suitability rules administered by the SEC and the self-regulatory bodies apply only when the broker recommends a transaction or a series of transactions to a customer. The unsolicited order to buy or sell received by a broker or dealer does not, standing alone, trigger a duty to dissuade an investor from carrying out his trading decision.

There are a number of other safeguards that public investors should not automatically lose when trading in financial futures. For example, the securities laws have specific restrictions against "performance" fees charged by investment advisers, since that type of compensation arrangement provides an adviser with an incentive to take undue risks with clients' funds. Similarly, securities self-regulatory organizations generally prohibit their members from sharing in customers' profits or losses. No corresponding limitations, however, are found under the commodities laws or the rules of the board of trade. The mandatory disclosure requirements imposed under the federal securities laws -- notably, the prospectus delivery requirements for securities options -- are far more elaborate than their counterpart under the commodities laws. Training, testing, competency, and supervisory requirements in the converging securities and commodities industries differ markedly. Apart from substantive standards, the securities industry self-regulatory bodies are more advanced in surveilling floor trading and play a considerably more active role in policing abuses in retail sales practices than do the commodities self-regulators. Over time this gap on the retail level may close if the newly-organized National Futures Association is adequately funded and staffed.

On the matter of speculative limits, I believe that the authority of the CFTC to set limits, even to previously established positions, is an important tool that the CFTC should possess. The wisdom of setting speculative limits at any particular level is a matter beyond my own expertise, but there is a more general proposition that should be observed. Under the securities laws, the notion of self-regulation derives its legitimacy from the SEC's complementary authority to oversee the operations of the

April 16, 1982

exchanges and to step in if the self-regulators do not sufficiently discharge their responsibilities. Similarly, I believe the CFTC, to ensure effective oversight of the self-regulatory process, should be vested with rulemaking authority over speculative limits that is identical in breadth to the authority exercised by the boards of trade. The difficulties which arose during the silver market crisis -- when the CFTC had to depend upon the boards of trade to set retroactive limits -- should not be repeated.

Finally, I would like to say a few words about the proper relationship of the states and the Federal government in protecting investors in our organized commodities and securities markets. Despite occasional differences, the SEC and the states have enjoyed a longstanding partnership in policing the securities markets and market professionals. The SEC, while larger than the CFTC, itself has limited resources, and the states have played a critical role in pursuing frauds that are local or regional in character. I am confident that if given similar authority to pursue fraudulent activity by professionals in the commodities markets that the states would do a similarly admirable job.

Sincerely,



Ralph C. Ferrara

Identical originals transmitted to:

The Honorable Timothy Wirth, Chairman
Subcommittee on Telecommunications, Consumer Protection
and Finance
Committee on Energy and Commerce
United States House of Representatives

The Honorable Alphonse D'Amato, Chairman
Subcommittee on Securities
Committee on Banking, Housing and Urban Affairs
United States Senate

The Honorable Jesse Helms, Chairman
Committee on Agriculture, Nutrition and Forestry
United States Senate