JOINT WRITTEN STATEMENT OF IRVING M. POLLACK AND HARVEY L. PITT, BEFORE THE HOUSE SUBCOMMITTEE ON TELECOMMUNICATIONS, CONSUMER PROTECTION, AND FINANCE OF THE HOUSE COMMITTEE ON ENERGY AND COMMERCE ON H.R. 5447 AND H.R. 5515.

April 23, 1982

INTRODUCTION

Mr. Chairman, Members of the Committee:

This written statement expresses the views of Irving M. Pollack and Harvey L. Pitt. For over thirty-three years, Mr. Pollack served with the Securities and Exchange Commission (the "SEC"), starting as a staff-attorney. Mr. Pollack subsequently became the Director of the SEC's Division of Trading and Markets, and the first Director of the SEC's Division of Enforcement. In 1974, Mr. Pollack was appointed a member of the Commission, where he served until his retirement in 1980. Mr. Pollack is now a lawyer and consultant in private practice, specializing in legal and policy issues relating to the capital markets. Harvey L. Pitt is a partner in the Washington/New York/London law firm of Fried, Frank, Harris, Shriver & Kampelman. Prior to joining his law firm, he served, for more than ten years, in a number of legal positions at the SEC; among other positions he held at the SEC, Mr. Pitt was Chief Counsel of the Commission's Division of Market Regulation and, during the last three years of his government service, Mr. Pitt served as the Commission's General Counsel.

In response to the invitation of Chairman Wirth, we are pleased to have the opportunity to testify today on H.R. 5447 and H.R. 5515. Both of these bills reflect, and attempt to respond to the regulatory concerns raised by the recent development of an ingenious array of "derivative" financial instruments (hereinafter referred to as "derivative financials") -- forward-looking financial investment instruments that are based upon one or more underlying securities.* These bills also take on added significance in view of the recent decision of the Court of Appeals for the Seventh Circuit, holding that the SEC lacks authority to regulate the trading on stock exchanges of one of these derivative financial instruments, options on so-called GNMA securities.**

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* The term "securities" is used herein to refer to instruments which are "securities" as defined under the federal securities laws, see e.g., 15 U.S.C. §§77b(b)(1), 78c(a)(10), 80a-2(a)(36), including securities that may be exempt securities under some provisions of the securities laws, see 15 U.S.C. §§77c(a)(3). For example, while certain provisions of the Securities Act of 1933 and the Securities Exchange Act of 1934 do not apply to "exempt securities," such as government debt obligation, the provisions pertaining to regulation of exchange trading, prevention of manipulation, deception and fraud, and recordkeeping and reporting, apply to all securities, including "exempt securities." The term "securities" is also used to refer to instruments such as certificates of deposit, which fall within the plain language of the definitional term "securities," but which, depending upon the context of the particular situation, may be found not to constitute a "security" for the purposes of one or more provisions of the federal securities laws. See, e.g., Marine Bank v. Weaver, 50 U.S.L.W. 4285 (March 8, 1982).

** Board of Trade of the City of Chicago v. Securities and Exchange Commission and Chicago Board Options Exchange, Incorporated, No. 81-1660, (7th Cir. March 24, 1982), (herein-

(Footnote continued)

It should be noted, at the outset, that both of us represent a variety of individual and institutional clients who may be interested in, or affected by, the proposed legislation we have been asked to address. The views expressed herein, however, are solely our own, personal, views and should not be attributed to any of our clients.

H.R. 5447 would codify the recent accord reached by the SEC and the Commodity Futures Trading Commission (the "CFTC") concerning each agency's respective jurisdiction over certain derivative financials.* The agreement would allocate to the SEC jurisdiction to regulate options on securities and options on groups or indices of securities.

The CFTC, on the other hand, would be given authority to regulate futures contracts on exempted securities (other

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after "Board of Trade v. SEC and CBOE"). The SEC has filed a Petition for Rehearing and Suggestion for Rehearing En Banc. (April 7, 1982). For a discussion of the significance and major issues addressed in the 7th Circuit's decision, see e.g. Pitt and Miles, "SEC, CFTC Jurisdictional Detente Undone by Court, Legal Times, April 13, 1982, p. 14, (a copy of which is attached).

GNMA securities are certificates issued by private institutions (primarily mortgage bankers) to represent interests in pools of government-underwritten residential mortgages. The owner of a GNMA certificate receives a proportion of the income generated as mortgagees in the pool repay their loans, and the timely payment of principal and interest to the GNMA owner is guaranteed by the Government National Mortgage Association.

** See Commodity Futures Trading Commission, Securities and Exchange Commission, "Joint Explanatory Statement," December 7, 1981.

than municipal securities), and on broad-based groups or indices of securities, as well as options on any such futures contracts.* It is this accord that the Seventh Circuit declared contrary to law late last month.**

In the weeks after the SEC/CFTC jurisdictional accord was first made public, trading in some of these new derivative products has already begun, and both the SEC and the CFTC have received applications to commence trading in others.*** H.R. 5515 is concerned with the rapid pace of these developments, and would impose a moratorium, barring any regulatory agency from approving or allowing the establishment of a market in futures or options on a group or index of securi-

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* The agreement provides, however, that neither futures contracts nor options on futures contracts will be permitted for individual corporate and municipal securities.

** See Board of Trade v. SEC and CBOE, supra.

*** The Kansas City Broad of Trade has begun trading futures based on the Value Line index, and on April 20, the CFTC approved a proposal by the Chicago Mercantile Exchange to trade futures based on Standard and Poor's Composite Index of 500 stocks. Applications are pending for trading by the International Monetary Market (using the Standard and Poors 500 index), New York Futures Exchange (New York Stock Exchange equity indices), Chicago Board of Trade (11 separate industry "portfolio" indices), and Commodity Exchange, Inc. (Standard and Poor's 500 index). See e.g., "Stock-Index Futures Get a Robust Start in Kansas City, Mo.," Wall Street Journal, February 25, 1982, p. 38; "Trading New Stock Index Futures Is Risky, But Contracts Permit Speculating, Hedging," Wall Street Journal, March 1, 1982, p. 44; "Emerging Index Futures," New York Times, March 8, 1982, p. D8; "Stock Index Futures", New York Times, March 15, 1982, p. D6; "Chicago Wins Index Futures Bid," New York Times, April 21, 1982, p. D12.

ties.* The rationale underlying the proposal for this moratorium was, first, that trading in such futures and options has not been demonstrated to further the accumulation of capital for investment in productive enterprise and, second, that the affected regulatory agencies could benefit from some "breathing room" to assess and anticipate market developments.

Although there are competitive considerations that may require careful attention, for example, stock index futures-trading has already begun on at least one Board of Trade, we believe that the generic moratorium approach of H.R. 5515 is a sensible interim response to some of the most serious problems posed by the development of derivative financials, and we support its adoption.** Although these instruments may serve some valid economic purposes, and may threaten no adverse economic effects, some current evidence suggests that these propositions are far from self-evident. In addition, these instruments raise many larger, macro-economic.

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* The bill proposes a moratorium during the period from February 1, 1982, until August 1, 1982. That period is nearly half expired and, presumably, would need to be revisited if the concept of a moratorium were incorporated in any legislation ultimately adopted by this Committee.

** Since the Kansas City Board of Trade has already commenced trading index futures, and the Chicago Mercantile Exchange is likely to have begun by the time moratorium legislation is enacted, we urge that legislation also embody a mechanism for an orderly suspension of such trading.

questions which remain unanswered. Given the absence of market generated demand for these instruments, and their potential use as vehicles for speculation by unsophisticated investors, we believe a "tread softly" approach is completely appropriate.

We find troubling, however, the more permanent response to derivative financials embodied in the jurisdictional allocation that H.R. 5447 would implement. We recognize that current law on the subject of the respective agencies' jurisdiction to regulate derivative financials is somewhat unclear,* and that this confusion has been the subject of

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* The debate has centered around the effect of three provisions in the Commodity Futures Trading Commission Act of 1974 ("CFTCA"). By amendments to the Commodity Exchange Act of 1936, the CFTCA grants the CFTC "exclusive jurisdiction" over accounts, agreements and transactions "involving" futures contracts, and defined the term "commodities" to include "all other goods and articles . . . and all services, rights, and interests, in which contracts for future delivery are presently or in the future dealt in . . . ." 7 U.S.C. §2(a)(1). Yet, the CFTCA also provides that "except as hereinabove provided, nothing contained in this section shall (i) supercede or limit the jurisdiction at any time conferred on the Securities and Exchange Commission . . . or (ii) restrict the [SEC] from carrying out [its] duties and responsibilities." 7 U.S.C. §2(a)(1).

a wide range of scholarly,* regulatory,** and judicial attention.***

We also agree that the nation in general and the financial markets in particular can only benefit from a final resolution of the jurisdictional dispute that has cast such a long and uncertain shadow over the regulatory arena

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* See, e.g., Russo & Lyon, "The Exclusive Jurisdiction of the Commodities Futures Trading Commission," 6 Hofstra L. Rev. 57 (1977); Guttman, "The Future Trading Act of 1978: The Reaffirmation of CFTC-SEC Coordinated Jursidiction over Security/Commodities," 28 Amer. U.L. Rev. 1 (1978); Saitlin, "Additional Developments on the Question of CFTC Exclusive Jurisdiction Over Commodity Vehicles," 33 Bus. Law. 2196 (1978); Hewitt, Commodities and Securities, 7 Sec Reg. L. J. 339 (19___); Johnson, "The Commodity Futures Trading Commission Act: Preemption as Public Policy," 29 Vanderbilt L. Rev. 1 (1976); Johnson, "The Perimeters of Regulatory Jurisdiction Under the Commodity Futures Trading Commission Act," 25 Drake L. Rev. 61 (1975); Bromberg, "Commodities Law and Securities Law -- Overlaps and Preemption," 1 Jour. Corp. Law 217 (1976).

** See, e.g., CFTC Interpretive Letter No.77-12 (Aug. 17, 1977); CFTC Interpretive Letter 77-11 (Aug. 17, 1977); Memorandum of the Office of the General Counsel of the Commodities Futures Trading Commission concerning the Exclusive Jurisdiction Over Futures Transactions, reprinted in, [1975-1977 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶20,117 (Dec. 3, 1975); Letter of Roderick M. Hills, Chairman, SEC (Nov. 13, 1975), reprinted in [1975-1977 Transfer Binder], Comm. Fut. L. Rep. (CCH) ¶20,117.

*** See, e.g., Board of Trade v. SEC and CBOE, supra; SEC v. American Commodity Exchange, Inc., 546 F.2d 1361 (10th Cir. 1976); SEC v. Univest, Inc., 405 F. Supp. 1057 (N.D. Ill. 1976).

for the last eight years. Nevertheless, while CFTC and the SEC may have generated the most appropriate compromise possible under the circumstances, we believe the Congress can, and should, do better. The issues posed by the development of derivative financials are sufficiently important as to warrant careful and complete consideration by the Congress.

In brief, the flaw we perceive in the SEC/CFTC jurisdictional accord is that it embodies a program of dual regulation, in which the form of the derivative instrument determines its regulated status. If the derivative is an "option," the SEC would regulate it; if it is a "future," or based upon a "future," the CFTC would regulate it.

We believe that today's sophisticated financial markets require a firmly-based jurisdictional test. We urge that the Congress eschew the compromise between the SEC and the CFTC, and, instead, adopt a jurisdictional test based upon the substance of a derivative financial. Such a test would consider the economic function of the various derivative financials, the highly interrelated nature of the markets for different derivatives and between the markets for derivatives and their underlying securities, and the need for a coordinated regulatory approach to foster the integrity of all markets concerned and to protect the interests of investors. Consideration of all these factors, we believe, would result in a jurisdictional dividing line based upon

the regulated status of the financial instrument upon which a derivative financial was based. Thus, where the underlying instrument is a security under the federal securities laws, the derivative should also be subject to such laws -- and to the regulatory jurisdiction of SEC.

Form Over Substance?

The jurisdictional accord allocates to the SEC jurisdiction over options on securities, and we fully support this aspect of H.R. 5447. The instruments underlying these particular derivatives are either securities, a group of securities, or securities indices, all matters of primary concern to the SEC. The markets for these options and the markets for their underlying securities are also highly interrelated; they exist side by side on the same securities exchanges, and they frequently share the same purchasers and the same broker-dealers. This interrelationship demands that the two markets be subject to co-ordinated regulatory oversight in order to preserve the integrity of both markets. This interrelationship also calls for a regulatory regime which, while sufficiently uniform to prevent a "market tilt" towards any particular instrument, is sufficiently attuned to the special risks and dangers inherent in each particular instrument to fully protect the investing public.

For example, the interrelationship between the options and securities markets and the need for coordinated regulation to prevent cross-market manipulation was graphically recounted in the SEC's study of the options markets.* As the Options Study described, the possibility for manipulation between the two markets are very real:

> A relatively small commitment of capital to an options position can result in substantial percentage gains if a favorable movement in the price of the underlying stock causes a corresponding favorable movement in the price of the option. An attempt to influence the price movement in a stock to benefit a previously established options position is referred to as a stock/option manipulation. If the attempted manipulation is of short duration, and involves a relatively slight price movement in the stock, the effect is often called minimanipulation. The incentive and opportunity for persons to attempt minimanipulations is demonstrated by the following series of stock and options transactions which the Commission staff recently alleged were effected by a marketmaker on the CBOE.**

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* Report of the Special Study of Options Markets to the Securities and Exchange Commission, Committee Print 96-IFC3, 96th Congress., 1st Sess. (December 22, 1978) (hereinafter "Options Study")

** The Options Study described the following example:

> In July, with IBM stock trading at 260, a marketmaker was short approximately 200 July 260 calls. The value of his short position would be enhanced if, by depressing the price of the stock, the marketmaker could cause a corresponding drop in the price of the July 260 calls. To accomplish

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The Options Study also observed that, because only a small movement in the price of the underlying stock will result in substantial percentage gains on the related options,

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> this goal, the marketmaker purchased 50 deep-in-the-money calls (the July 240s) and submitted an exercise notice with respect to these contracts.* He then increased his short position in the July 260 call options by selling an additional 100 calls at prices ranging from 2-7/16 down to 2-1/4. Within a few minutes, he sold 3,900 shares of the underlying stock acquired through exercise of the July 240 calls at declining prices ranging from 260-1/2 down to 259-1/2. The options market quickly reacted to the price decline in the underlying stock and the July 260 calls declined in price permitting the marketmaker to profitably cover, within a matter of minutes, a substantial part of his short position in the July 260 calls at prices ranging from 1-7/8 to 2-1/16. While the dollar profit from closing his short options position was relatively small (generally less than 1/2 point), the profit represented a percentage gain of between 20-25 percent on an options position initially valued at slightly over $70,000. The profit was made despite the slight transaction costs incurred by the marketmaker to sell the stock, and the smalltime premium paid to purchase the deep-in-the-money calls.
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> The purchase of the deep-in-the-money calls was used by the marketmaker as an alternative (and inexpensive) method of acquiring the stock needed to sell in an attempt to depress the market without subjecting himself to the restrictive provisions of the Commission's short sale rules, e.g., 17 CFR 240.10a-1, or to the risk of being short both the stock and the options. Under options exchange rules (or interpretations of such rules), a holder of an option who submits an irrevocable exercise notice is deemed to be long the underlying stock. See, e.g., Interpretation .02 to CBOE Rule 11; CBOE Educational Circular No. 10 (August, 1975).

stock/option minimanipulation may even be accomplished without the manipulator engaging in any actual stock transactions. According to the Options Study, a manipulator might "prevent a move in the stock price or move the price merely by placing a large order just above or below the market which could momentarily influence the price of the stock in the opposite direction."*

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The SEC/CFTC jurisdictional accord implicitly recognizes these relationships between the options and securities markets and the need for coordinated regulation -- and in that respect implicitly employs a jurisdictional test based on substance, not form -- in allocating to the SEC jurisdiction over options on securities. But the accord then fails to apply these same principles to other derivative financials and shifts to a form over substance approach when confronted with derivative financials labelled "futures."

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* Options Study, supra, at 173-175. "Effecting stock transactions to depress or prevent a rise in the price or a stock in order to prevent near-the-money, at-the-money, or slightly in-the-money call options from being exercised, and to protect a previously received premium, is referred to as capping. Similarly, effecting stock transactions to prevent a decline in the price of a stock, in order to assure that put options written on the stock will not be exercised and that premiums previously received will be protected, is referred to as pegging. These practices are most likely to occur just before expiration of the options series, when the probability of exercise is highest. Capping and pegging are forms of minimanipulation."

We submit that the same factors supporting SEC jurisdiction over options on securities also support SEC jurisidction over all derivative financials, including futures and derivatives based on futures. First, futures and options on securities are functionally equivalent in all key respects. Both are instruments that permit the transference of risk in connection with buying and selling an underlying financial instrument, and both derivatives can often be used interchangeably for the same economic purposes, by the same investors, who use the same broker-dealers to execute their trades. Second, because of the interrelationships that exist between markets in options and futures on securities and the underlying securities, transactions in any one market may influence or be influenced by the other, and, therefore, effective regulation requires a uniform, coordinated regulatory approach. Third, because of the convergence and interrelationship of the markets for various derivative financials, uniform regulation is necessary, not only for the protection of investors, but also to prevent a market "tilt" to the least regulated segments of the market.

1. Functional Similarities Between Financial Futures and Financial Options

There are, of course, substantial differences between the market for options on securities and the traditional futures markets. The traditional futures markets are designed to

facilitate agricultural trade. Accordingly, futures contracts were written on agricultural commodities, like soybeans or pork bellies. Participants in the traditional futures markets are largely farmers and manufacturers who buy and sell futures contracts to hedge against the rapid price fluctuations which have historically characterized many agricultural products. Large, sophisticated public investors also participate in these traditional markets for agricultural futures as "speculators," seeking not to hedge against price fluctuations, but to absorb the risks these fluctuations pose in return for potentially large profits. These "speculators" provide the liquidity necessary to create an effective hedging mechanism for farmers and the manufacturers.

As the Wall Street Journal recently described:

> Generations of students got their introduction to commodities futures with the textbook tale of the canny miller. Having loaded up on grain to grind into flour, he now worries that the price of grain -- and flour -- will precipitously fall. So -- and this is why he's canny -- he sells a grain futures contract. If the price of grain falls, he must sell his flour for less, but he'll make up the loss buying back his futures contract for less than he sold it.*

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* "Financial Futures Surge As Banks, Industrial Firms Move Into Market," Wall Street Journal, March 23, 1982, p. 37.

Such traditional markets for agricultural futures have little relevance to the securities markets. They do not play a capital-raising function and they generally do not function as "investment" markets.

With the advent of futures contracts on securities and securities aggregates, however, the wall dividing the futures markets and the securities markets has crumbled. Participants in the new futures markets are no longer farmers and manufacturers seeking to protect the fruits of their labors from the ravages of an uncertain market. Rather, in the new futures markets for financial instruments, all the participants are, in a sense, investors. Some participants are purchasing financial futures on low margins in the hope of reaping large profits should the prices of the underlying securities rise sharply. Others are more conservative investors who, by using various combinations of financial futures and other financial instruments, are attempting to protect against rapid fluctuations in the prices of underlying securities.

Indeed, investors, brokers and traders in financial futures are increasingly the same investors, brokers and traders that participate in the markets for options and underlying securities. As the Wall Street Journal again noted:

> In recent months, big commercial banks and more Wall Street securities firms have entered the financial futures markets as

brokers and traders. Other financial institutions, such as pension funds and savings and loan associations, as well as some industrial corporations, also have joined the game.

Not so long ago, so foreign was the notion of futures trading to some industrial companies that they "reacted to us with xenophobia," says John Eckstein, a broker at A. G. Becker, Inc., Chicago. That's changing now. Even for financial institutions, which might be expected to appreciate financial futures readily, the change in attitude has been marked. "A year ago, they were saying, 'We'll have to look into it,'" says Larry Morgan, a Dean Witter Reynolds, Inc. vice president in Chicago. "Now they're doing it."*

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* Id.; accord, Letter from CFTC Chairman Stone, dated February 23, 1982, to Representative Jones, Chairman, House Subcommittee on Conservation, Credit, and Rural Development, House Committee on Agriculture, regarding Proposed Amendments to the Commmodity Exchange Act at 2 (hereinafter "Stone, February 23, 1982") ("In the last few years, the distinctions between securities and commodities have eroded. The largest commission firms in commodities are not specialty houses; they are affiliates of the major securities firms. Commodities customers and securities customers are increasingly drawn from the same lists. Three of the oldest and largest commodity houses have recently merged with securities giants. The Chicago Board of Trade, which had cut all ties to its offspring, the Chicago Board of Options Exchange, during the independence phase, is now talking of a reassociation. The New York Stock Exchange created its own commodities affiliate and then negotiated a cooperation agreement with the Chicago Board of Trade. I would feel safe in predicting that other commodities and securities exchanges will soon follow suit with their own affiliations or mergers. The approval by the CFTC just last week of an application to trade futures, on a common stock index is a final proof that the lines have been blurred. The independence phase is quickly giving way to the merger phase.")

The convergence of the futures and securities markets should not be surprising since futures on financial instruments are directly comparable to options on such instruments. Despite the formal differences between futures and options on financial instruments, the two investment vehicles are distinctly similar.* Both futures and options enable investors to transfer the risk inherent in holding a position, either long or short, in the underlying securities.** Both futures and options are derivatively priced, reflecting the prices at which the underlying securities are being traded in the capital markets. And both futures and options provided investors with similar risk management opportunitites -- leveraged investments of relatively high risk and hedged investments of relatively low risk.***

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* See, e.g., Board of Trade v. SEC and CBOE, supra, Slip. Op. at 5-6; Letter from SEC Commissioner Pollack, dated February 19, 1980, to CFTC Chairman Stone, Re: The Application of the Kansas City Board of Trade for Contract Market Designation in a Future Based On the Value Line Stock Market Average at 3 (herinafter "Pollack, Feb. 19, 1980").

** See, e.g., Board of Trade v. SEC and CBOE, supra, slip op. at 5; Moriarity, Phillips & Tosini, "A Comparison of Options and Futures in the Management of Portfolio Risk," Financial Analyst Journal 61 (Jan./Feb. 1981).

*** Of course, financial futures and financial options are not identical. A future is a contract, imposing binding and reciprocal obligations on both parties, to buy and sell a fixed quantity of a given commodity at a future time at an agreed upon price. See, e.g., Bromberg, supra, at 242. An

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Futhermore, both types of derivative financials raise similar policy concerns from the perspective of their impact on the American economy.* Neither lead directly to new capital formation. Indeed, trading in financial futures and options may adversely effect capital formation, since investors who otherwise might have invested in the underlying securities

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option is a unilateral contract, in which imposing an obligation upon one party to buy or sell the underlying security at any time during the life of the option. See, id. at 257-260. The difference in the nature of the obligation imposed by a future and an option, as a practical matter, however, is insignificant, since the party to a futures contract can escape from his binding obligation by engaging in an offsetting transaction; for example, if he holds a contract to buy, he can offset by entering a contract to sell an equivalent amount of the same commodity. But see p. 34, infra, footnoote ¶(2).

Purchasers of futures and options are also exposed to different financial risks. In an options contract, for example, the maximum loss for the purchaser is the amount of the premium paid for the option. The futures purchaser risks not only the initial margin payment made on the future, but also any funds invested to satisfy additional margin calls which might be made in the event the market moves against the purchaser. Once again, however, the futures purchaser is able to minimize his greater risk of loss by engaging in an offsetting liquidating transaction. See, e.g., Board of Trade of Chicago v. SEC, supra, Slip. Op. at 3-4. But see p. 34, infra, footnote ¶(2).

* Prepared Statement of the Honorable Harold M. Williams, Chairman, Securities and Exchange Commission, Before the Subcommittee on Conservation and Credit of the House of Representatives Committee on Agriculture Concerning H.R. 10285, February 22, 1978, at 12-13, reprinted in, Extend Commodity Exchange Act: Hearings on H.R. 10285 Before the House Subcommittee on Conservation and Credit, 95th Cong., 2d Sess. 193-196 (1978).

may choose instead to purchase derivative financials, especially in light of the smaller initial capital outlay required, and the promise of quick and large profits.

In light of these similarities, and the existing regulatory jurisdiction over a broad range of securities and options on such securities, it makes little sense to subject futures on securities, securities aggregates, and securities indices, to a different set of laws and regulations, administered by a separate agency -- particularly a young agency shouldering the already heavy burden of regulating agricultural futures.

2. Market Interrelationships

A second reason why a jurisdictional allocation based on substantive, rather than formalistic factors, should be employed stems from the very nature of the derivative instruments -- their prices and value are primarily dependent on the prices of their underlying financial instruments. Thus, if manipulation of the market for the underlying instruments lead to distorted prices for these instruments, then the prices for futures and options on these instruments will also be distorted. Conversely, any manipulation of the markets for futures and options may adversely affect the market for the underlying investments. In short, the very nature of the pricing mechanism for derivatives demands that the markets for futures, options, and their underlying securities be subject to integrated regulation.

Of course, an integrated regulatory system cannot assure that market manipulation will never occur. But it does alleviate the special surveillance difficulties inherent in a bifurcated regulatory system, which create the risk that manipulation in one market to benefit a position held in another may go undetected. The silver crisis presents a good example. During the silver crisis, the Hunts and others used the futures markets to corner the market on silver by taking very long positions in silver futures contracts and by then demanding delivery under the contracts.* Because the activity in the futures market was unknown to those in the underlying silver market, the strategy could be successfully implemented. As the CFTC's study explains:

> By taking positions in the futures market these individuals were able to contract for a substantial amount of cash silver beyond the purview of regular cash-market participants. Since futures markets are not normally used as a source of supply for a large quantities of a commodity, the presence of this demand was not immediately known in the marketplace. By the time substantial deliveries of silver were taken by these groups and the increase in demand was revealed to the market, the major longs in the futures market had already established the bulk of their positions."**

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* Commodity Futures Trading Commission Report to the Congress in Response to Section 21 of the Commodity Exchange Act, (May 29, 1981) (hereinafter "CFTC Section 21 Study").

** Id. at 14-15.

3. Investor Protection and Market Integrity

A critical third factor to consider in drawing a jurisdictional dividing line is whether the placement of that line enhances or reduces protections for investors and market integrity. This test has several facets. For example, where the regulatory burdens on one side of the dividing line are different from that on the other, there is a danger, first, that if presented with a choice between either of two functionally similar means of risk-management, some prospective participants will seek out the market containing the least regulatory restrictions. Indeed, the very existence of regulatory disparities where markets are interrelated may cause market professionals to move to the arena of least regulatory interference, and then to steer investors into that area. This not only presents serious questions as to the competitive implications of such a regulatory "tilt," but also raises the second critical question of whether participants in the less regulated sector of the markets are being afforded adequate investor protections and assurances of market integrity. This concern becomes particularly acute, where, as here, the markets for derivative financials have converged and the markets for financial futures are drawing increasing numbers of investors -including smaller investors -- who previously participated in the markets on the other side of the line.

A jurisdictional test for derivative fiancials must therefore take into account the investor protections and market safeguards afforded by the prospective regulator. And, where regulations and enforcement capability are deficient, the presumption should be against allocating derivative financials to that agency. A comparison of the regulations administered by the CFTC with the protections available under the federal securities laws clearly demonstrates that the securities laws and regulations provide superior investor protections and assurances of market integrity.

a. Jurisdictional scope

Regulation of the securities and options marketplace takes place within a broad framework of complementary enforcement authority which operates to provide the marketplace and investors with several layers of protection. Primary regulatory authority, of course, is vested with the SEC. In addition, the securities laws impose upon the securities self-regulatory organizations, -- the NASD and the exchanges -- the duty to enforce the securities laws and regulations of the SEC,* while recognizing in them supplementary powers to

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* See 15 U.S.C. § 78f(b)(1) ("An exchange shall not be registered as a national securities exchange unless the Commission determines that . . . [s]uch exchange is so organized and has the capacity to carry out the purposes of this chapter . . . and to enforce compliance by its members and persons associated with its members, with the provisions

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promulgate and enforce rules for the benefit of the marketplace and the investor.* Moreover, the federal securities laws also preserve the authority of the states to regulate both the issuance of securities** and their trading in the

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of their chapter [and] the rules and regulations thereunder. . . ."); 15 U.S.C. § 78o-3(b)(2) ("An association of broker and dealers shall not be registered as a national securities association unless the Commission determines that . . . [s]uch association is so organized and has the capacity to be able to carry out the purposes of this chapter and . . . to enforce compliance by its members and persons associated with its members, with the provisions of their chapter, [and] the rules and regulations thereunder. . . .").

* See 15 U.S.C. §78f(b)(5) ("An exchange shall not be registered as a national securities exchange unless the Commission determines that . . . the rules of the exchange as designed to prevent fraudulent and manipulative acts and practices, to promise just and equitable principles of trade trade . . . and, in general, to protect investors and the public inherent. . . ."); 15 U.S.C. §78o-3(b)(6) ("An association of brokers and dealers shall not be registered as a national securities association unless the Commission determines that . . . the rules of the association are designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade . . . and, in general, to protect investors and the public interest. . . ."); 15 U.S.C. §78bb(b) ("Nothing in this chapter shall be construed to modify existing law with regard to the binding effect (1) on any member of or participant in any self-regulatory organization of any action taken by the authorities of such organization to settle disputes between its members or participants . . .")

** 15 U.S.C. §77r ("Nothing in [the Securities Act of 1933] shall affect the jurisdiction of the Securities Commission (or any agency or office performing like functions) of any state or territory of the United States, or the District of Columbia, over any security or any person"); see, e.g., SEC v. Timetrust, Inc., 28 F.Supp. 34 (N. D. Cal. 1939);

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Nation's secondary markets.*

The regulatory framework overlaying the futures market however, lacks some of these critical protections. For example, although the futures exchanges are vested with broad powers to regulate the conduct of their members,** it is generally recognized that futures exchange regulation is not stringent.*** The CFTC also lacks the resources, manpower, and sometimes the will to enforce exchange compliance with their self-regulatory duties.**** And although the CFTC has registered a futures

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(Continued footnote)

Crosby v. Weil, 382 Ill. 538, 48 N.E.2d 386 (1943): Travelers Health Ass'n v. Comm., 188 Va. 877, 51 S. E.2d 263 (1949), aff'd, 339 U.S. 643 (1950); Grenader v. Lefkowitz, 367 N.Y.S. 2d 17, 47 A.D.2d 359 (1975), modified on other grounds, 397 N.Y.S. 2d 1003, 42 N.Y. 2d 907, 366 N.E. 2d 1357 (1977).

* 15 U.S.C. §78bb(a) ("Nothing in [the Securities Exchange Act of 1934] shall affect the jurisdiction of the Securities Commission (or any agency or office performing like functions) of any State over any security or any person insofar as it does not conflict with the provisions of the chapter or the rules and regulations thereunder").

** 7 U.S.C. §§ 7, 7a.

*** See, e.g., "GAO Urges CFTC to Tie Contract Approal to Mart Surveillance Ability," Securities Week, March 1, 1982, at 7 (describing GAO report criticizing exchange rule enforcement programs) (hereinafter "GAO Report").

**** See, e.g., "English Eyes Two-Year Test for NFA Without CFTC User Fees," Securities Week, March 1, 1982, at 6; GAO Report, supra, at 7. (GAO report criticizing CFTC oversight of exchanges and CFTC unwillingness to deny contract market designation to exchanges with admittedly deficient compliance programs).

self-regulatory organization similar to the NASD,* the futures market complement -- the National Futures Association -- is not expected to be fully operative for a matter of years.**

Finally, the Commodity Exchange Act itself denies the CFTC the aid of supplemental state enforcement activities. The Act preempts direct state regulation of futures transactions under state securities laws,*** and arguably preempts indirect state regulation through other state laws.****

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* 7 U.S.C. § 6.

** See Chrisman & Weirzinski, "The CFTC: Hedging Against the Futures Boom," District Lawyer, March-April 1982 at 51-52; Letter from CFTC Chairman Stone, dated September 18, 1981, to Senator Jesse Helms, Chairman, Senate Committee on Agriculture, Nutrition and Forestry, re: CFTC Reauthorization of Commodity Options Trading at 17 (hereinafter "Stone, Sept. 18, 1981").

*** See, e.g., Texas v. Monex International Ltd., 527 S.W. 2d 804 (Tex. Ct. App. 1975); cf. Minnesota v. Coin Wholesalers, 250 NW. 2d 583 (Minn. 1976).

**** Compare, e.g., Massachusetts v. Lloyd Carr. & Co., [1977-1980 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 20,561 (Mass. Super. 1978) (State consumer protection law not preempted) with Haines v. First Commodity Corp. of Boston, 2 Comm. Fut. L. Rep. (CCH) ¶ 21,088 (Mass. Super. 1980) (State consumer protection law preempted); compare Paine, Webber, Jackson & Curtis, Inc. v. Conaway, 2 Comm. Fut. L. Rep. ¶ 21,200 (N.D. Ala. 1981) (state statute prohibiting futures contracts where delivery of underlying commodity not intended pre-empted) with Paine, Webber, Jackson, & Curtis, Inc., v. Lambert, 389 F.Supp. 417 (E.D. Tenn. 1975)(state statute prohibiting futures contracts where delivery of underlying commodity not intended not preempted)(dicta); see also Dart Partnership v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 2 Comm. Fut. Law. Rep. (CCH) ¶ 21,129 (D. Md. 1980) (state common law claims not preempted); see generally, Comment, The Pre-Emption Doctrine and the Commodity Futures Trading Commission Act: In Favor of State Law, 11 Indiana L. Rev. 467 (1978).

The shortcomings inherent in the Commodities Exchange Act's pre-emption of the enforcement power of the fifty states are vividly illustrated by a comparison of two commodity option scandals which occurred in the last decade. In the early 1970's, for example, prior to enactment of the CFTCA, Harold Goldstein and other dealers defrauded investors of approximately $70 million through a "naked" commodities options fraud.* In this scheme, dealers sold options on unregulated commodities futures contracts to small, unsophisticated investors. Because these dealers did not possess an inventory of futures contracts to back up the options they sold, the dealers kept their operations going by paying off those investors who exercised their options with funds generated from the sale of options to others, and by manipulating the underlying futures market in order to prevent investors from exercising their options. The several states

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* Regulation of commodities options has had a long and turbulent history. In 1935, Congress responded to a series of abuses which piecemeal regulation had been unable to control by barring all trading in options on commodities regulated under the Commodity Exchange Act of 1936. See Commodity Exchange Act, Ch. 545, § 4, 49 Stat. 1491 (1936). Since prior to the enactment of the CFTCA, the CEA defined the term "commodity" to mean only "wheat, cotton, rice, corn, oats, barley, rye, flax seed, grain sarghums, mill feeds, butter, eggs, and Solanum tubersom (Irish potatoes), wool, wool tops, fats and oils (including lard, tallow, cottonseed oil, peanut oils), cottonseed meal, cottonseed, peanuts, soybean meal, livestock, livestock products, and frozen concentrated orange juice," see 7 U.S. § 2, firms such as Mr. Goldstein's found they were lawfully able to trade in options on so-called "world commodities" -- e.g., coffee, cocoa, sugar, platinum, and silver.

brought this fraudulent scheme, and the innumerable fraudulent practices used to further its success, to a halt by the commencement of enforcement proceedings under their state securities laws.*

The states found themselves helpless, however, when another scandal erupted during 1976 and 1977, arising from the widespread sale of "London" options on commodity futures contracts.** By means of "boiler room" sales campaigns,

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* See, e.g., In re Goldstein Samuelson, 3 Blue Sky L. Rep., ¶ 71,095 (Okla. Sec. Comm'n. Feb. 23, 1973); Cal. Corp. Comm'n Release No. 29-C, 3 Blue Sky L. Rep., ¶ 8679 (Feb. 8, 1973); Shapiro v. First Federal Commodity Trust Co., 3 Blue Sky L. Rep. ¶ 71,058 (Md. Cir. Ct., Baltimore City, Feb. 23, 1973), injunction made permanent, 3 Blue Sky Law Rep., ¶ 71,071 (Md. Cir. Ct., Baltimore city, May 30, 1973); see generally, Long, "Commodity Options Revisited," 25 Drake L. Rev. 75, at 215-217; Lower, "The Regulation of Commodity Options," 1978 Duke L.J. 1095, 1105-1108 (1978).

** When Congress enacted the CFTA in 1974, it expanded the definition of "commodity" beyond the agricultural products listed above to include "all other goods and articles . . . and all other services, rights and interests in which contracts for future delivery are presently or in the future dealt in." Despite this broadening of the definition of the term "commodity," Congress continued the ban on option transactions involving the agricultural commodities enumerated prior to 1974. 7 U.S.C. § 6c(a). With respect to options on the remaining commodities, Congress gave the Commission the power to bring such options within the statutory bar, or to permit their trading subject to whatever terms and conditions the CFTC might prescribe. 7 U.S.C. § 6c(b).

The Commission initially decided to permit trading in such options and adopted interim rules to govern their off-exchange trading, see 41 Fed. Reg. 16,685 (1976), pursuant to which trading in "London Options" was undertaken. See, e.g., British American Commodity Options Corp. v. Bagley, 552 F.2d 482 (2d Cir.), cert. denied, 434 U.S. 938 (1977); See generally, Lower, "The Regulation of Commodity Options," 1978 Duke L. J. 1095, 1111-1117 (1978).

"cold calls," misleading sales literature, and a variety of high pressure sales techniques, dealers persuaded thousands of small unsophisticated investors to invest in these options.* Although the CFTC took action against these fraudulent activities,** the CFTC was simply unable to bring them under control. And when the states attempted to do so by bringing suit under their securities laws, the courts held that the CFTCA's grant of "exclusive" jurisdiction to the CFTC pre-empted the states' securities laws.*** The CFTC finally was forced to publicly admit defeat**** and to simply suspend trading in these options.*****

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* See, e.g., Myron v. Martin, 670 F.2d 49, 50-51 (5th Cir. 1982); Kelley v. Carr, 442 F. Supp. 346 (W.D. Mich. 1977).

** See, e.g., CFTC v. Muller, 570 F.2d 1296 (5th Cir. 1978); CFTC v. British American Commodity Options Corp., 560 F.2d 135 (2d Cir. 1977); CFTC v. Crown Colony Commodity Options, Ltd., 434 F. Supp. 911 (S.D.N.Y. 1977); CFTC v. J.S. Love & Assocs. Options Ltd., 422 F. Supp. 652 (S.D.N.Y. 1976).

*** See, e.g., International Trading Ltd. v. Bell, 556 S.W. 2d 420 (Ark. 1977), cert. denied, __U.S.__ (1978); Clayton Brokerage Co. v. Mouer, 531 S.W.2d 805 (Tex. 1975).

**** "CFTC Proposes London Option Sales Suspension," Wash. Post, Jan. 26, 1978, §D, at 11, Col. 1.

***** See 17 C.F.R. § 32.11; see generally, Lower, supra, at 1073. In 1978, Congress responded to these developments by banning the sale of all commodities options, with the exception of certain "trade" and "dealer" options, and directed that trading should not resume until the CFTC had demonstrated to Congress its ability to effectively regulate them. See 7

(Footnote continued)

In addition to the jurisdictional and enforcement difficulties which have hampered the CFTC's efforts to protect investors and foster market integrity, the CFTC's ability to protect investors and regulate the marketplace is also limited by the fact that the CFTC has not implemented, or required the futures exchanges to implement, many measures that are fundamental protections under the securities laws. Thus, for example, in

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(Continued footnote)

U.S.C. §6c(c); H.R. Rep. No. 1181, 95th Cong., 2d Sess. 45 (1978); S. Rep. No. 850, 95th Cong., 2d Sess. 23-25 (1978); see also Precious Metal Associates v. CFTC, 620 F.2d 900 (1st Cir. 1980)

The CFTC has recently reauthorized limited trading in commodities options. See 46 Fed. Reg. 54000; Regulation of Domestic Exchange-Traded Commodity Options, 2 Comm. Fut. L. Rep. (CCH) ¶ 21,163 (hereinafter "Options Pilot Program.") These rules permit each exchange to carry on options trading on one type of futures contract for which the exchange has been designated as a contract market. See id.; see also American Stock Exchange Inc. v. CFTC, 528 F. Supp. 1145 (S.D.N.Y. 1982).

The states' experience with the "London" options scandal led to the introduction of a bill to amend the Commodity Exchange Act to allow the states to regulate futures and options under state laws identical to the Commodities Exchange Act. Congress rejected this legislation, however, in favor of a provision granting the states standing to bring suits under the Commodity Exchange Act in their parens patriae capacity. See, H.R. Rep. No. 1181, 95th Cong., 2d Sess. 4648 (1978); see also 7 U.S.C. § 13a-2. The states remain unsatisfied, however, and Senators Roth and Rudman are planning to introduce legislation to restore to the states much of their regulatory authority over futures. Wall Street Letter, March 1, 1982 at 2; see "Senate Seen Likely to Prevail in Support of User Fees," Securities Week, March 15, 1982 at 7.

the areas of personnel and supervision, disclosure, suitability, fees, margin requirements, and floor trading, as well as with respect to available remedies, CFTC safeguards fall far short of those administered by the SEC. For example:

b. Personnel and supervision

All securities exchanges require that employees of member firms be registered with the exchange. In order to register to trade options, the salesperson must first pass an options qualifying examination.* Some exchanges also require that options sales persons undergo training in order to qualify for registration.**

In contrast, the CFTC does not require that futures salespersons pass a qualifying proficiency examination relatting to futures, or options on futures in order to register and do business.*** Most futures exchanges also do not require

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* See, e.g., Amex Rule 341, 2 ASE GUIDE (CCH) ¶ 9391; CBOE Rule 3.4(c), CBOE GUIDE (CCH) ¶ 2054; SEC, Report of the Special Study of the Options Market 298 (Committee Print for the use of the House Committee on Interstate and Foreign Commerce 1979)(hereinafter "Options Study"); Lipton, "The Special Study of the Options Market: Its Findings and Recommendations," 7 Sec. Reg. L.J. 299, 316 (1980)(hereinafter "Lipton").

** See, e.g., Amex Rule 341, 2 ASE GUIDE (CCH) ¶ 9391; CBOE Rule 9.3, CBOE GUIDE (CCH) ¶ 2203; Options Study, supra, at 298; Lipton, supra, at 317.

*** See, Stone, Oct. 18, 1981, at 5, 12, n. 20; CFTC Staff, Customer Protection Pursuant to the Commodity Exchange Act; As Amended: A Report to the Inter-Agency Task Force, 22 n.21 (1979)(hereinafter "CFTC Consumer Protection").

salespersons to pass qualifying examinations.* The dangers thereby posed to investors are graphically illustrated by the study undertaken by the Department of Treasury and the Federal Reserve Board of the Treasury futures markets, which disclosed that "some market participants . . . were contacted by over-zealous salesmen from brokerage houses who were promoting futures actively but appeared to have an insufficient understanding of such transactions."**

The options customer is also protected by the duty of brokerage firms to supervise the professional conduct of their salespersons, a duty imposed by the SEC,*** the NASD**** and the exchanges.***** Any brokerage firm which fails to carry out its supervisory obligations is subject to SEC sanctions.****** Apart from this general duty of supervision,

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* CFTC Consumer Protection, supra, at 22 n.21; see, e.g., Commodity Exchange Inc.: Bylaws, Rules and Regulations, Chapters 2, 6; but see NYFE Rule 205(a), NYFE GUIDE (CCH) ¶ 2371.

** Vol. II, Treasury/Federal Reserve Study of Treasury Futures Markets 63 (1979)(hereinafter "Treasury/FRB Study").

*** See, e.g., Reynolds & Co., 39 S.E.C. 902, 916 (1960); R.H. Johnson & Co., 36 S.E.C. 467 (1955), aff'd., 231 F.2d 523 (D.C. Cir.), cert. denied, 352 U.S. 844 (1956).

**** See, e.g., NASD Rules of Fair Practice, Art. III §27(F) NASD MANUAL (CCH) ¶2177, Options Study, supra, at 314.

***** Lipton, supra, at 318.

****** 15 U.S.C. §78o(b)(4)(e).

all exchanges require that the accounts and retailing techniques of options salespersons be supervised by a Registered Options Principal, an individual who has also passed a comprehensive written options examination* administered by the NASD.** The options exchanges also require the brokerage firms to designate a principal or "Senior Registered Options Principal", who is an officer or general partner of the firm, to be responsible for overall supervision of options customers accounts.***

The futures customer, however, does not receive this same degree of supervisory protection. Although futures merchants have a general duty to supervise the activities and accounts of their employees**** the futures markets contain no equivalent of a Registered or Senior Registered Options Principal.*****

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* See, e.g., CBOE Rules 9.2, 9.8 CBOE GUIDE, (CCH) ¶¶ 2302, 2308; PSE Rule VI, Sec. 14, PSE GUIDE (CCH) ¶ 4213; Amex Rule 920, 2 ASE GUIDE (CCH) ¶9720; Options Study, supra, at 316.

** Options Study supra, at 318,

*** See, e.g., In the Matter of Michael Tennenbaum, [Current] Fed. Sec. L. Rep. (CCH), ¶ 83092 (Jan. 19, 1982); Options Study, supra, at 333.

**** 12 C.F.R. §166.3.

***** Stone, Sept. 18, 1981 at 12, n.20.

c. Disclosure

In deciding whether to purchase a securities option, the securities option customer will have the benefit of a prospectus prepared by the Options Clearing Corporation ("OCC") pursuant to Section 5 of the Securities Act of 1933.* This prospectus, currently 56 pages long,** describes in considerable detail the listed options traded on the options exchanges, their risks, the mechanics and strategies of options trading, margin requirements, tax aspects of options trading, and the OCC itself. Exchange rules require that this prospectus be delivered to every customer at or prior to the time his account is approved for listed options trading.*** Pursuant to Section 10(a)(3) of the Securities Act,**** this prospectus is revised continually to ensure that it contains current information; i.e., information which is no more than sixteen months old.***** The futures customer,

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* See 15 U.S.C. §77e.

** See, Prospectus, The Options Clearing Corporation.

*** See, e.g., Amex Rule 921, 2 ASE GUIDE (CCH) ¶ 9721; CBOE Rule 9.7, CBOE GUIDE (CCH) ¶ 2307.

**** See 15 U.S.C. §77j(a)(3).

***** See id;, Options Study, supra, at 377.

in contrast, receives only a boilerplate "Risk Disclosure Statement."*

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* This statement simply provides:

> This statement is furnished to you because Rule 1.55 of the Commodity Futures Trading Commission requires it.
>
> The risk of loss in trading commodity futures contracts can be substantial. You should therefore carefully consider whether such trading is suitable for you in light of your financial condition. In considering whether to trade, you should be aware of the following:
>
> (1) You may sustain a total loss of the initial margin funds and any additional funds that you deposit with your broker to establish or maintain a position in the commodity futures market. If the market moves against your position, you may be called upon by your broker to deposit a substantial amount of additional margin funds, on short notice, in order to maintain your position. If you do not provide the required funds within the prescribed time, your position may be liquidated at a loss, and you will be liable for any resulting deficit in your account.
>
> (2) Under certain market conditions, you may find it difficult or impossible to liquidate a position. This can occur, for example, when the market makes a "limit move."
>
> (3) Placing contingent orders, such as a "stop-loss" or "stop-limit" order, will not necessarily limit your losses to the intended amounts, since market conditions may make it impossible to execut such orders.
>
> (4) A "spread" position may not be less risky than a simple "long" or "short" position.

(Footnote continued)

In addition, the options exchanges, subject to SEC oversight, have developed detailed standards to govern the content and manner of presentation of options advertising.* The CBOE, for example, by rules prohibits advertising which contains unsupportable promises, exaggerated or unwarranted claims, or unsupportable opinions or forecasts.** The rule also requires that the member's advertisements advise

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(Continued footnote)

> (5) The high degree of leverage that is often obtainable in futures trading because of the small margin requirements can work against you as well as for you. The use of leverage can lead to large losses as well as gains.
>
> This brief statement cannot, of course, disclose all the risks and other significant aspects of the commodity markets. You should therefore carefully study futures trading before you trade.

See 12 CFR §1.55(b). The rule also forbids any futures merchants to make any substantive additions to this statement. Id. §1.55 (a)(1).

Under the CFTC's recent Options Pilot Program, the purchaser of an option on a future is provided with a slightly more elaborate document, but one that still falls far short of the OCC prospectus. See Options Pilot Program, supra, at 25,294.

* Pollack, Feb. 19, 1980 at 9-10.

** CBOE Rule 9.21, CBOE GUIDE (CCH) ¶ 2321. The other options exchanges hae comparable advertising rules. See, e.g., Amex Rule 991, 2 AMEX GUIDE (CCH) ¶ 9791; MSE Art. XIII, Rule 4, MSE GUIDE (CCH) ¶ 1623; PSE Rule VI, Sec. 35, PSE GUIDE (CCH) ¶ 4234; Phlx Rule 1049, PHLX GUIDE (CCH) ¶ 3049.

customers of the availability of the OCC prospectus, and alert the customers to the special risks inherent in options trading. Any statement referring to the possible benefits of options must be accompanied by a statement of corresponding risks. The advertising may not contain recommendations, or past or projected performance figures, including annualized rates of return. To enforce compliance with the advertising rules, the options exchanges require that all advertising be reviewed and approved in advance of its use by both a Registered Options Principal in the member's firm and by the exchange itself.

The futures customer receives far less protection in the area of advertising. Not all futures exchanges have advertising rules,* and among those that do, the standards governing the content of the advertising are not uniform.** Most importantly, however, no futures exchange requires that advertising be approved by a knowledgeable official within the futures firm or by the exchange before it is disseminated to the public.

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* See, e.g., Charter, Bylaws, and Rules of the New York Cotton Exchange.

** Compare, NYFE Rule 357, NYFE GUIDE (CCH) ¶ 2628 with Rules and Regulations of the Board of Trade of the City of Chicago, Chap. 2, Rule 287.

d. Suitability

The options customer is also protected by what is known as the "suitability doctrine." In general, this doctrine requires that a broker recommend to its customers only those securities transactions which the broker reasonably believes are suitable in light of the customer's financial position and investment goals. Suitability rules are imposed by the NASD* and by the securities exchanges ("know your customer" rules).** The SEC has also imposed a suitability rule on SECO brokers; i.e., brokers who are not registered on securities exchanges.***

The securities options exchanges have also developed special suitability rules relating to options transactions. These rules generally require that a broker recommending the sale of a put or uncovered call option have reasonable grounds to believe that the recommendation is not unsuitable for such customers after reasonable inquiry concerning the customer's investment objectives, financial information and needs,

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* See NASD, Rules of Fair Practice, Art. III, Sec. 2, NASD Manual (CCH) § 2152.

** See, e.g., NYSE Rule 405, NYSE GUIDE (CCH), § 2405; AMEX Rule 411, 1 AMEX GUIDE (CCH), § 9431.

*** 17 C.F.R. § 204.15b-10.3.

and have a reasonable basis to believe that the investor has such knowledge and experience in financial matters that the customer may reasonably be expected to be capable of evaluating the risks of the transaction.* Violation of the suitability rules of a self-regulatory organization exposes the errant broker to SRO** or SEC*** disciplinary action.

The CFTC, however, has to date refused to impose suitability rules upon futures market professionals. Although an advisory committee, made up largely of futures industry professionals, advised the CFTC to adopt such rules in 1975,****

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* CBOE Rules 9.7, 9.9, CBOE GUIDE, (CCH) ¶¶ 2307, 2309; Amex Rule 923, 2 AMEX GUIDE (CCH) ¶ 9721; Midwest Stock Exchange, Art. XLVM, Rule 5, MSE GUIDE, (CCH) ¶ 2115; Pacific Stock Exchange ("PSE") Rule X, Section 18(c), PSE GUIDE (CCH) ¶ 4993; Philadelphia Stock Exchange, Rule 1026, PHLX GUIDE (CCH) ¶ 3206.

** See, e.g., Philips & Co., 37 SEC 66 (1956); Thomas Arthur Stuart, 22 SEC 196 (1945), Roach, "The Suitability Obligations of Brokers; Present Law and the Proposed Federal Securities Code," 29 Hastings L.J. 1067, 1119-1121 (1978)(hereinafter "Roach").

*** See, 15 U.S.C. §78s(h)(2)(B),(h)(3)(B). The SEC may initiate direct proceedings even if the NASD, or both the NASD and the exchange, have already taken action against the same respondents. See, e.g., Shearson, Hammermill & Co., 42 S.E.C. 811, 852 n.88 (1965); see generally Roach, supra, at 1121. The SEC is also empowered to bring disciplinary proceedings against a SECO broker for violation of the SEC's suitability rule. See 15 U.S.C. §§ 78o(b)(4),(b)(6).

**** Report of the Commodity Futures Trading Commission Advisory Committee on Commodities Futures Trading Professional, [1976] Comm. Fut. L. Rep. (CCH), Supp. 24, pt II; see Hudson, "Consumer Protection in the Commodities Futures Market," 58 B.U.L.R. 1, 14-18 (1978); Stone, February 23, 1982 at 9.

the Commission declined to do so.* Because the CFTC has not adopted suitability rules to govern futures and options trading, it is unclear whether recommendation of unsuitable trades constitutes a basis for disciplinary action by the CFTC.**

The deficiencies inherent in the CFTC scheme were once again illustrated by the Treasury and Federal Reserve Board Study of the Treasury futures markets, which disclosed that some market participants had complained that "futures salesmen had recommended trades which would have been inappropriate for their institutions." The study accordingly recommended that serious consideration be given to the adoption of "formal customer suitability standards."***

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* See 43 Fed. Reg. 31886 (1978).

** Compare In re Luizi, Comm. Fut. L. Rep. (CCH), ¶20,811 (April 17, 1979), with Jensen v. Shearson Hayden Stone, Inc., 2 Comm. Fut. L. Rep. ¶ 21,062 (July 28, 1980).

Although the CFTC also proposed a suitability rule to govern its Options Pilot Program, see Proposed Regulation of Domestic Exchange Traded Commodity Options, 2 Comm. Fut. L. Rep. ¶ 21,209 at 24,987, the CFTC backed off from the rule in its final regulations. Options Pilot Program, supra, at 25,295. Although the final regulations impose a duty on the futures merchant to "acquaint itself with the personal circumstances of the option customer, the rules stress that "this requirement is not a 'suitability' rule as such rules have been composed in the securities industry." Id. In addition, the extent of the inquiry mandated is left to the "prudent discretion" of the futures merchant. Id.

*** Treasury/FRB Study, supra, at 62, 63.

e. Fees

Suitability rules are particularly important since certain compensation arrangements may provide market professionals with incentives to recommend unsuitable trades to their customers. The securities option customers are protected against these incentives, since the federal securities laws and rules of self-regulatory organization contain specific provisions to prevent over-reaching and to reduce conflicts of interest. For example, Section 205(1) of the Investment Advisers Act of 1940 generally prohibits investment advisers from charging "performance" fees,* in recognition that such a fee arrangement provides an adviser with an incentive to take undue risks with clients' funds. For the same reasons, rules of the self-regulatory organizations prohibit members or associated persons from sharing in customer profits or losses in any account carried by the member, except to the extent that they contribute capital to the account.**

The futures customer lacks comparable protections. Although commodity trading advisers are required to describe their fee structure to prospective clients,*** neither the

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* 15 U.S.C. § 80b-5(1).

** See, e.g., NASD Rules of Fair Practice, Section 19(f), NASD Manual (CCH) ¶ 2196.

*** 17 C.F.R. 4.31(a)(4).

CFTC nor any exchange has a rule which prohibits performance-based fees. Most futures exchanges also lack rules barring sharing in customers profit or losses.* The absence of such prohibitions further compounds the risks posed by trading in futures.

f. Margin requirements

Although margin requirements serve formally distinct legal functions in the securities and futures markets, they have one similar practical effect; they set an investment threshold which determines whether an investor will enter a particular market and the size of the position the investor will take in that market. The margin requirements differ quite dramatically with respect to purchasers of securities options versus purchasers of securities futures.

Pursuant to its authority under Section 7 of the Securities Exchange Act of 1934** the Federal Reserve Board has promulgated Regulation T to establish margin regulations

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* See, e.g., Bylaws and Rules of the New York Mercantile Exchange; Rules of the Chicago Mercantile Exchange; but see NYFE Rule 208, NYFE GUIDE (CCH) ¶ 2835.

** 15 U.S.C. 78(g). In conferring margin authority upon the Federal Reserve Board, Congress intended not only to further macro-economic ends, but to protect investors from excessive risks incurred by trading upon little or no margin. See S. Rep. No. 792, 73d Cong., 2d Sess. 3 (1934); S. Rep. No. 1455, 73d Cong., 2d Sess. 11 (1934); H.R. Rep. No. 1383, 73d Cong., 2d Sess. 8 (1934). See also Meisel v. North Jersey Trust Co., 218 F. Supp. 274 (S.D.N.Y. 1963); Remar v. Clayton Securities Corp., 81 F. Supp. 1014, 1017 (D. Mass. 1949).

for securities options. No credit may be extended for the purchase of an option.* Moreover, an investor who writes an option, if uncovered, must deposit at least 30 percent of the value of the underlying stock, plus the amount the option is "in the money" or minus the account the option is "out of the money".** Margin requirements are also imposed by the self-regulatory organizations.*** In combination, these requirements prohibit an investor from overextending himself financially, and protect the securities markets from undue speculation.****

The CFTC, however, lacks the authority to impose margin requirements upon participants in the futures market.*****

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* 12 C.F.R. 220.8(f).

** 12 C.F.R. 220.8(j).

*** Options Study, supra, at 674; see, e.g., CBOE Rules 12.1-12.12, CBOE GUIDE ¶¶ 2171-2176; PSE Rule XI, PSE GUIDE (CCH) ¶¶ 5100-5190.

**** Options Study, supra, at 674.

***** See 7 U.S.C. § 7a(12); Hudson, supra, at 10 n.72. Although there is case law indicating that Regulation T is inapplicable to futures transactions, see Birenbaum v. Bache & Co., Inc., 555 S.W.2d 513 (Tex. Ct. App. 1977)(Regulation T inapplicable to margin commodity trading account), the Federal Reserve Board has asserted that it possesses the authority under the Securities Exchange Act of 1934 to apply margin requirements upon futures contracts on stock indices, see letter from FRB Chairman Paul Volcker, dated February 18, 1982, to CFTC Chairman Philip Johnson, Re: KBCOT Value Line Average Future Contract, and has invited interested parties to submit comments on the establishment of margin requirements on stock market index futures contracts and related instruments.

Athough the futures exchanges set margin levels, these margins rules are not subject to the normal regulatory oversight of the CFTC.* In addition, because margin levels are the valve which governs trading volume, and thereby industry income, the exchanges have a sharp conflict of interest which has manifested itself in extremely low margin levels usually less than five percent.** These low margins, of course, create exceptionally highly leveraged instruments which attract the market speculator.*** Indeed, Commissioner Stone of the CFTC has singled out the low margin requirements of

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* Interagency Study of the Silver Market, Additional Views of Commissioner Stone at 35 (hereinafter "Additional Views").

** Id.

*** As Commissioner Stone explains:

> In the silver market, for example, . . . margins were generally lower than 5 percent. When silver was selling at roughly $10 an ounce the margin reported was still only 30 cents an ounce. In a 30 cent margin, every time the price rose a dollar, the value of the trader's initial investment more than quadrupled. A speculator who entered the long side of the silver market with an initial margin deposit of only $7500 in April of 1979 would have had over one million dollars in profits in that position at the January high. A speculator today can control a million dollar position in treasury bill futures with less than $2000 in margin payments. This is of enormous importance to the potential speculator of today. When inflation threatens to erode asset growth in traditional investment forms, individuals increasingly turn to highly leveraged alternatives.

Additional Views, supra, at 35-36.

of the futures industry as the "single strongest inducement" to the "massive, unchecked and unnecessary speculation" in the futures market today.* Commentators have also expressed the view that the difference in margin requirements between the securities and futures markets is one of the "keys" to the recent expansion of the futures markets.** One need only to recall the recent crisis in the silver market for a stunning example of the danger such low margins present.

g. Floor trading

Once the option customer and the futures customer have safely placed their orders, the practice of dual trading may pose a threat to the safety of the customer's investment. For example, a floor broker might be tempted to hold a customer's order in his pocket while executing an identical order for an unspecified account, then decide later whether the trade was for himself, a colleague, or the customer. To protect investors, the SEC has forbidden floor brokers to trade simultane-

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* Opening Statement of Commodity Futures Tradiing Commission Chairman James M. Stone Before the Senate Subcommittee on Agricultural Research and General Legislation, Senate Committee on Agriculture, Nutrition, and Forestry, May 1, 1980 at 5 (hereinafter "Stone, May 1, 1980").

** Additional Views, supra, at 36. In its Option Pilot Program, however, the CFTC has engaged in a form of margin regulation, by requiring purchasers of options on futures to pay the entire option premium within a reasonable time following purchase of the option. Option Pilot Program, supra, at 24,290.

ously for themselves and their customers,* as have the options exchanges.** Because order executions in the securities markets are time-stamped to permit sequencing and reconstruction of trading patterns for subsequent examination, these rules can be enforced in the securities markets.

Although Congress authorized the CFTC to study dual trading on the floors of the futures exchanges in order to determine whether to ban it,*** the agency soon learned that it was unable to do so because it could not reconstruct the sequence of trading that took place on the exchange floors.**** To overcome this obstacle, the CFTC directed

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* SEC Rule 11a-1, 17 CFR § 240.11a-1.

** See, e.g., AMEX Rules 111, 950.

*** 7 U.S.C. §6j.

**** See Hudson, supra, at 35. The importance of being able to reconstruct the pattern of trading to ensure compliance with regulatory requirements has been noted:

> In order for an exchange (or any observer) to be able to detect trading abuses, there must exist surveillance systems in both the options exchanges and, for some abuses, in the exchange trading the underlying security. These systems must be able to monitor trading activities and also produce a physical record which would reconstruct such trading activity at any particular juncture -- such record being known as an "audit trail." Basically, the reconstruction of the trading activity must be able to relate not only the elements involved in a specific transaction, but also what was generally taking place in the market when the specific transaction was executed.

(Footnote continued)

the exchanges to time stamp each trade report to the nearest minute to create an "audit trail"* a requirement the CFTC staff indicated would be technologically feasible.** The exchanges complained, however, that this interfered with their traditional floor practices, and the CFTC retreated. The CFTC substituted a rule which requires only bracketing of trades to the nearest half-hour,*** a time period long enough for many of the abuses to occur and sufficiently

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(Continued footnote)

> In reconstructing the transaction, it is necessary to identify the brokers involved in a transaction, the time it took place, the price and number of shares agreed upon, what firms cleared the trade, in what capacity the broker was executing the transaction, and ultimately, if the transaction was made. To create the total market picture, a surveillance system must also be able to tell what bids, offers, and orders were present in the trading crowd at the time that a specific transaction occurred. The reconstruction of specific transaction information along with the corresponding market picture allows an exchange to identify possible fictitious and prearranged trades, options manipulations, and the misuse of material market and inside information. Without this ability to reconstruct, an exchange might be unable to enforce its own rules or comply with its regulatory obligations under the Act.

Lipton, supra, at 308; accord, Options Study, supra, at 219.

* 41 Fed. Reg. 46134 (Dec. 23, 1976).

** Id.

*** 45 Fed. Reg. 79753 (Dec. 2, 1980); 12 CFR §1.35(g).

in precise to prevent accurate study of the problem.* Thus, although the CFTC has adopted rules to control what it believes, albeit without a supporting data base, to be the most pernicious and widespread abuses posed by dual trading,** the larger questions posed by Congress remain to be answered.***

i. Remedies

Assuming the worst, that both the options customer and the futures customer sustain losses, customers may turn to examine their available judicial remedies. The option customer will discover that he has an implied cause of action under Section 10(b) and rule 10b-5 of the Securities Exchange Act, the major antifraud provisions of the securities laws.**** If

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* Letter from CFTC Chairman Stone, dated February 23, 1982, to Representative Ed Jones, Chairman, House Subcommittee on Conservation, Credit, and Rural Development, House Committee on Agriculture, regarding proposed amendments to Commodity Exchange Act at 10 (hereinafter "Stone, Feb. 23, 1982").

** See 12 CFR §155.2.

*** Stone, February 23, 1982, at 10.

In its Options Pilot Program, the CFTC also only requires bracketing of trades to the nearest half-hour. Options Pilot Program, supra, at p. 25,299.

**** See, e.g., Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 730 (1975); Superintendent of Insurance v. Bankers Life & Casualty Co., 404 U.S. 6, 13 n.9 (1971); Kardon v. National Gypsum Co., 69 F. Supp. 512 (E.D. Pa. 1946).

the options customer can prove his losses were caused by an exchange's failure to enforce compliance its members with the federal securities laws and the exchange's rules, the customer also has an implied cause of action under Section 6 of the Exchange Act against the exchange.* If his injuries were caused by a broker who violated the margin requirements of Regulation T, the customer may have an implied right of action under Section 7 of the Exchange Act.** And finally, should customer losses be sustained in violation of an exchange or NASD rule promulgated pursuant to authority granted under the Securities Exchange Act, such as the suitability rule, the customer may well have an implied cause of action under the pertinent rule.***

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* See, e.g., Baird v. Franklin, 141 F.2d 238 (2d Cir.), cert. denied, 323 U.S. 737 (1944); Hochfelder v. Midwest Stock Exchange, 503 F.2d 364 (7th Cir.), cert. denied, 419 U.S. 875 (1974); Hughes v. Dempsey-Tegeler & Co., Inc., 534 F.2d 156, 165 n.4 (9th Cir.), cert. denied, 429 U.S. 896 (1976).

** See, e.g., Remar v. Clayton Securities Corp., 81 F. Supp. 1014 (D. Mass. 1949); Spoon v. Walston & Co., Inc., 478 F.2d 246 (6th Cir. 1973); Landry v. Hemphills Noyer & Co., 473 F.2d 365 (1st Cir.), cert. denied, 414 U.S. 1002 (1973); Palmer v. Thomson & McKinnon Anchincloss, Inc., 427 F. Supp. 915 (D. Conn. 1977); but see Utah State University v. Bear, Stearns & Co., 549 F.2d 164, 170 (10th Cir.) cert. denied, 434 U.S. 890 (1977).

*** See, e.g., Buttrey v. Merrill Lynch, Pierce, Fenner and Smith Inc., 410 F.2d 135 (7th Cir.), cert. denied, 396 U.S. 838 (1969) implied right of action for breach of NYSE "know your customer" rule); Greyes v. Paine, Webber Jackson & Curt's Inc., 389 F. Supp. 678 (D. Wyo. 1975) (implied right of action for breach of NYSE "know your customer" rule and NASD "suitability" rule); Starkinan v. Seroussi, 377 F.

(Footnote continued)

The futures customer, on the other hand, will find that the availability of an implied right of action under the Commodities Exchange Act is open to doubt.* Additionally, the CFTC does not support the existence of an implied right of action against futures exchanges in connection with their self-regulatory functions,** even in cases involving gross negligence or gross dereliction of self-regulatory duties, because exposure to liability might "chill the self-regulatory inclinations of the exchanges."*** Finally, the courts have held that no implied cause of action exists against a broker for violation of exchange rules.****

(Continued footnote)

Supp. 578 (S.D.N.Y. 1974) (implied right of action for violation of NYSE "know your customer" rule); but see, e.g., Landy v. Federal Deposit Insurance Corporation, 486 F.2d 139 (3d Cir. 1973, cert. denied, 416 U.S. 960 (1974) (no implied cause of action for breach of NYSE "know your customers" rule). The majority of courts hold that breach of suitability and know your customers rules is actionable where their violation is "tantamount to fraud;" see generally Roach, supra, at 1194.

* Compare Leist v. Simplot, 638 F. 2d 283, (2d Cir. 1980), (cause of action implied), cert. granted, 450 U.S. 910 (1981) with Rivers v. Rosenthal & Co., 634 F.2d 774 (5th Cir. 1980) (no implied cause of action).

** Stone, February 23, 1982 at 11-12.

*** Id. at 12.

**** See, e.g., Hofmayer v. Dean, Witter & Co., 459 F. Supp. 733 (N.D. Cal. 1978).

j. Protection against broker insolvency

The securities option customer is also protected by the Securities Investor Protection Act of 1970 ("SIPA").* SIPA established a fund,** administered by the Securities Investor Protection Corporation ("SIPC"),*** to ensure that customers of insolvent broker-dealers are reimbursed. Subject to certain limited exceptions, all broker-dealers registered pursuant to Section 15 of the Securities Exchange Act of 1934**** are required to be members of SIPC***** and to contribute to the fund.****** Should the SEC or any self-regulatory organization learn of facts that lead it to believe that any SIPC member subject to its jurisdiction is in or approaching financial difficulty, it is required to notify SIPC immediately.******* If SIPC determines that the member has failed or is in danger of failing to meet its obligations to customers,******** SIPC may apply to a federal court for a

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* 15 U.S.C. §78aaa et seq.

** 15 U.S.C. §78ddd.

*** 15 U.S.C. §78ccc.

**** 15 U.S.C. §78o.

***** 15 U.S.C. §78ccc(a)(2).

****** 15 U.S.C. §78ddd(c),(d),(e).

******* 15 U.S.C. §78eee(a)(1).

******** 15 U.S.C. §78eee(a)(3).

decree appointing a trustee* who, among other things, will distribute to customers any customer cash and securities held by the members.** The SIPC fund may, subject to certain dollar limitations, advance cash to provide prompt payment and satisfaction of these customer funds and securities.***

The futures customer, however, receives none of these protections, since there is no futures market equivalent to SIPA, or SIPC.

* * * *

The foregoing comparison of the protections available under the federal securities laws with the protections provided by the commodities laws clearly highlights the major shortcomings, gaps and enforcement inadequacies inherent in the CFTC's regulatory presence. Experience has taught that the CFTC has been a weak and sometimes reluctant regulator -- and that investors and the markets have suffered thereby.

Given this situation, and the interrelationships between markets for financial futures and options and between both such derivatives and the securities upon which they are based, we believe that the interests of investors and the markets as a whole would be served if derivative financials and their

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* 15 U.S.C. §78eee(c).

** 15 U.S.C. §78fff.

*** 15 U.S.C. §78fff-3.

underlying securities were subject to the same scheme of regulation -- the more complete and effective provisions of the federal securities laws. It would be unwise, we believe, to place the markets for new derivative financials under a jurisdictional umbrella which has been demonstrated to have major leaks, especially when such a jurisdictional allocation raises the additional troubling prospect of "tilting" the markets in favor of the sectors that are least adequately regulated.

Need For A Moratorium

In view of our foregoing comments and concerns, we support enactment of H.R. 5515, which would impose a moratorium until August 1, 1982, on the trading of derivatives on stock groups or stock indices.* These derivatives appear to pose particular dangers to the capital market and to require particular stringent regulatory evaluation and control. For, example, one convict who recently testified on his own part in commodity scams informed a Senate panel that "for a shady operator, a future on a stock index 'is like putting steak in front of the eyes of a

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* As noted at the outset of this statement, however, since trading in stock index futures has already begun on at least one Board of Trade, and may commence soon on others, a moritorium must be coupled with a mechanism for orderly suspension of such trading activity. Without such a suspension during the moritorium period, firms that were able to quickly start up stock index trading markets would enjoy an unfair competitive advantage. Moreover, since the moritorium period specified in H.R. 5515, February 1-August 1, 1982, is nearly half over, we assume that the six-month moritorium period will be shifted to commence as of the date of enactment of the moritorium legislation.

starving man.'"* And a CFTC review of KCBT, the major exchange upon which trading in stock indices futures is now taking place, revealed serious defeciencies in KCBT's ability to detect possible price manupulation.** Thus, the need for careful and thoughtful action in this area is clear.

The justification offered to support trading in instruments such as derivatives based upon stock groups and indices is that they will serve the traditional functions futures have always performed, i.e., price basing and hedging functions.*** These justifications, however, are open to serious question.

First, it is doubtful, to say the least, whether these instruments will serve any price discovery purpose. The market for the securities comprising the group or indices itself reflects investors' perceptions of the future returns of the individual securities, and the market is generally recognized as efficient in the sense that the new information is quickly translated into appropriate price changes. Under these circumstances, a derivative in a stock group index is unlikely to provide significant additional price discovery with respect to the stocks comprising the index.****

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* "Johnson Proposes Giving States Power Over Off-Exchange Scams," Securities Week, March 1, 1982 at 4.

** GAO Report, supra, at 7.

*** See Vernon, "Stock Index Futures: Is There Life After Death for the Securities Markets?," 35 Bus. Law. 823, 824-27, 832 (1980) (hereinafter "Vernon").

**** Pollack, February 19, 1980 at 15.

This is confirmed by an internal CFTC staff memorandum which addresses the merits of Kansas City Board of Trade's Value Line Average futures contract proposal. The memorandum states that "the Division has identified no substantial evidence to indicate that existing financial-futures markets are utilized for price-basing purposes,"* and concedes that "a futures contract which is based on a stock-index can [not] reasonably be expected to be used for price basing."**

It is also questionable whether the owner of securities could or would use options or futures on a securities group or indices to hedge a stock position. For example, the groups and indices at issue are comprised of up to 1,700 number of stock issues.*** Since the average investor does not hold such a widely diversified portfolio, he or she would be unable to use the options and futures on such groups and indices to protect his or her holdings.

Even persons holding a large diversified portfolio are unlikely to use the stock group/indices derivatives as a hedging tool. First, it is unlikely that the stock position and the stock group or index underlying the derivative will correlate

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* Memorandum from the Division of Economics and Education to the CFTC, dated February 9, 1982, Re: Application of the Kansas City Board of Trade for Designation as a Contract Market in the Value Line Composite Average at 70 (hereinafter "CFTC Memo Re: KCBOT")".

** Id. at 6; accord, CFTC Section 21 Study, supra, at 22.

*** See, CFTC Memo Re: KBCOT, supra, at 2 (Value Line Index).

to a significant degree. Absent this correlation, of course, the derivative can serve no hedging function.* Indeed, where there is this imperfect correlation, the derivative "hedge" may actually accentuate potential loss or gain if the general market, as measured by the group or index, moves in a direction contrary to the hedged position.**

Second, a number of tried and tested methods to hedge against adverse price movements already exist and are used by holders of diversified portfolios. For example, when faced with volatile or declining prices, managers of portfolios reduce their exposure to loss by selling equities in the cash market and buying fixed income or short-term interest-bearing securities with the proceeds.*** Managers also protect their portfolios purchasing or selling put or call options on individual stock issues.**** Whether portfolio managers would be willing to abandon these traditional hedging devices for the more speculative and uncertain derivatives on stock aggregates and indices is presently unclear.

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* Indeed, one broker has noted that "the only potentially successful indexes are the narrowly based ones.... More aggressive portfolio managers might buy IBM stock and sell an individual index, hoping IBM will outsell the industry, but I don't see much interest for general indexes. I can't see Dreyfus hedging an entire portfolio. "Firms Turn Wary Eye to Value Line Index," Securities Week, February 22, 1982 at 7.

** Pollack, February 19, 1980 at 6.

*** CFTC Memo Re: KCBOT, supra, at 46-47.

**** See, e.g., Pozen, "The Purchase of Protective Puts by Financial Institutions," Financial Analysts Journal, July/August 1978.

Third, even assuming portfolio managers would be willing to use derivatives on groups or indices as a hedging tool, they may be prohibited by law from doing so. Given the speculative nature of options and futures on stock groups and indices, use of such derivatives would appear to pose serious questions in light of the stringent regulatory requirements governing the investment activities of pension funds,* insurance companies,** and mutual funds.***

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* For example, managers of insured and noninsured private pension plans are bound by the fiduciary responsibiilty standard set forth in Section 404 of the Employee Retirement Income Security Act of 1974 (ERISA). This standard requires managers to minimize the risk of large losses and to act with the care, skill, and diligence of a "prudent man" in carrying on their investment activities. In light of the larger losses which are possible on a futures contract, and the evidence indicating that the "vast majority" of participants in the futures markets lose money, see, e.g., Long, "The Naked Commodity Option Contract As A Security," 15 Wm. & Mary L. Rev. 211, 223 (1973), it could constitute a breach of fiduciary duty for a manager of a pension fund's portfolio to invest in a derivative on a group or index of securities.

** The regulatory restrictions placed on insurance companies also may prevent insurance companies from using such derivatives. For example, the New York State Insurance Commission has classified all future positions as speculation, and therefore outside the "investment" permitted to companies registered in that state. CFTC Memo Re: KCBOT, supra, at 58. The Insurance Commission has also refused the request of the Equitable Life Assurance Society of the United States to use interest rate futures to hedge the interest rate risk of their debt portfolios. Id. n.26; see "Insurers See Financial Futures Market As Hedge Against Rate Swings, The Wall Street Journal, May 8, 1981.

*** The CFTC staff has also noted that investment companies will probably be unable to use these derivatives, since most funds' charters prohibit all futures positions -- hedging as well as speculative. CFTC Memo Re: KCBOT, supra, at 69. Even assuming that the charter restrictions were avoided, the staff has reported that "[t]he current regulatory environment of the mutual-fund industry may also provide a significant obstacle to mutual funds' use of a stock index futures contract." Id.

Finally, the lack of economic justification for these derivative instruments is also suggested by the fact that the impetus for development of these instruments has not come from the pension funds or mutual funds or other managers of diversified stock portfolios for whose benefit these derivatives have allegedly been created. Rather, the impetus has come from the firms that wish to market them.

That the economic justification offered to support these instruments appears suspect tends to confirm that the instruments are what they appear to be at first glance -- risky devices for speculation, little more than glorified gambling. In reality, the purchaser of such derivative instruments is doing nothing more than gambling that the value of the stock group or index will increase or decrease over a specified time. Indeed, the CFTC has determined that "to date, the financial futures markets have been used more for speculation by the general public" than for hedging,* and the Executive Vice President of KBOT has stated that "[w]e honestly believe that speculators will be the prime movers in this contract."** Furthermore, the speculative purpose of the derivatives is also confirmed by the fact that although a futures contract by definition calls for future delivery of the underlying commodity,*** the jurisdictional accord requires that derivatives or

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* CFTC Section 21 Study, supra, at 22-23.

** Vernon, supra, at 829.

*** See 7 U.S.C. § 2.

stock groups or indices be settled by cash payments, and not by delivery of the securities comprising the group or index.

These derivatives raise several broader questions which deserve serious study before their trading is allowed. For example, what effects will trading in these instruments have on the markets for the underlying securities? Will their trading distort stock prices by diminishing the depth and liquidity of the underlying equity markets? What impact will the trading of these instruments have on the capital formation process? Will they divert funds unduly from productive investment and into speculation? As Representative Glickman noted three years ago,

> "no one, not the CFTC, not the SEC not OMB, and not the GAO, has any substantive idea how much money has moved out of the equity markets and into the futures markets during the past several years. In fact, no one in a position to know seems to have the foggiest idea of how the development of futures in financial instruments, including securities, will affect our capital markets and the economy in general.*

These are serious and important questions which must be answered before futures and options on stock groups and indices are injected into the financial marketplace.

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* H.R. Rep. No. 1181, 95th Cong., 2d Sess. 158 (1978).