M E M O R A N D U M

June 18, 1982

TO: Chairman Shad

FROM: Douglas Scarff

SUBJECT: Agenda for June 22, 1982 Meeting with CFTC on Regulatory Differences

Attached is an agenda for your meeting with Chairman Johnson scheduled for June 22 on differences in commodities and securities regulation. To prepare for the meeting, I thought it might also be useful for you to have an updated version of the chart submitted along with your most recent Congressional testimony comparing the regulation of the securities options and commodities markets.

The chart reflects the CFTC's current regulations of the futures markets. We understand, however, that the CFTC is considering developing a proposal to apply to the futures markets some of the relatively more rigorous investor protection rules recently adopted by the CFTC to govern commodity options. Accordingly, it may be particularly useful to focus on the rule enhancements made by the CFTC with respect to commodity options in preparing for next week's meeting.

Agenda for June 22 Meeting
Between Chairman Shad and Chairman Johnson

I. Substantial Regulatory Differences Which the Respective Agencies (or their Regulated Exchanges) Have the Authority to Address

A. Customer Protection Rules

1. Suitability and Account Opening Requirements

2. Restriction of Time for Receiving Customer Margin Payments

3. Disclosure

4. Supervision

5. Advertisement and Sales Literature

6. Testing

7. Safekeeping of Customer Funds

B. Surveillance and Regulatory Restrictions on Manipulation

1. Surveillance Information Sharing Between

a. Options and Futures Exchanges Trading Options or Futures on the Same Underlying Instruments

b. Futures Exchanges Trading a Stock Aggregate and the Primary Stock Exchange for the Underlying Securities

2. Audit Trail

3. Speculative Position Limits

II. Substantial Regulatory Differences Which Would Require Congressional Action to Revise

A. Enforcement and Customer Remedies

1. Enforcement Remedies

a. Civil Penalties

b. Standard of Proof

2. Customer Remedies

a. Availability of Private Rights of Action

b. Reparations/Customer Arbitration

B. Public Interest Standard

1. CFTC Economic Purpose Requirement

C. Emergency Powers

D. SIPC

E. Margin

III. Clarification of Areas Where Financial Futures and Options Regulation Are Comparable but Differ From Stock Regulation

A. Clearing Fund Guarantees

APPENDIX

REGULATION OF OPTIONS AND FUTURES

The chart below summarizes several of the principal rules and regulations governing securities options and futures (and options on futures).

OPTIONS	FUTURES
I. Substantial regulatory differences which the respective Agencies (or their regulated exchanges) have the authority to address	
A. CUSTOMER PROTECTION RULES	
1. Suitability and Account Opening Requirements	
a. Suitability	
The rules of the options exchanges, NYSE and NASD (options SROs) prohibit member firms from recommending to any customer any options transaction unless they have reasonable grounds to believe that the entire recommended transaction is not unsuitable for the customer on the basis of information furnished after reasonable inquiry concerning the customer's investment objectives, financial situation and needs.	There are no provisions in the CFTC or board of trade rules governing the suitability of recommended futures transactions. While there also are no securities-type suitability rules governing commodity options, as noted in part D. below, FCMs must provide oral disclosures concerning commodity options at the time they open a customer's account that are tailored to the personal circumstances of the customer
They also prohibit broker-dealers from recommending opening transactions unless they have a reasonable basis for believing that the customer has such knowledge and financial experience that he can be expected to be capable of evaluating, and financially can bear, the risks of the transaction.	
b. Account Opening	
The rules of the options SROs require that in order to engage in options trading, a customer's account must be specifically approved for options trading.	The CFTC and commodity exchanges do not impose restrictions on the opening of futures accounts, although, as Chairman Johnson has noted in previous testimony, some

OPTIONS	FUTURES
(I.A.1.b. Continued)	
Before opening the customer's account, a broker-dealer must exercise due diligence to learn the essential facts as to the customer, his investment objectives, and his financial situation. In particular, the broker-dealer must seek to obtain and verify from natural person customers 15 specific categories of information, such as investment objectives, income, net worth and investment experience. Account approval must be in writing and can only be made by a qualified branch office manager or other supervisor. Exchange rules also require separate account approval before a customer may trade debt security options (whether or not the customer's account already is approved for stock options trading).	firms may impose voluntary requirements as to net worth and other matters. As noted above and discussed in part D. below, an FCM before opening a commodity options account, must make certain disclosures to a customer and make an investigation of the customer's financial condition, objective and sophistication. The record of the information obtained must be reviewed and approved by an officer or other supervisor of the FCM before the account may be opened.
2. Additional Margin Posting Time Periods	
Open options positions are marked-to-the-market daily. Federal Reserve Board Regulation T provides that additional margin must be deposited with the customer's broker within seven business days.	Open futures positions are marked-to-the-market daily. Persons with open positions that have moved away from the market are required to post additional margin the following business day.

OPTIONS	FUTURES

3. Disclosure

The federal securities laws and the options SRO rules require that options investors receive at or before the time their accounts are approved for trading, the OCC prospectus, which describes in detail the terms, mechanics, risks and uses of options. In addition, detailed disclosure about particular new options products (such as options on GNMAs and Treasury securities) is provided in separate supplements to the OCC prospectus.

Disclosure about futures is provided to customers in a risk disclosure statement that discusses generically the risks and characteristics of futures. The futures risk disclosure statement does not provide customers information concerning particular futures contracts, such as financial futures. The text of the risk disclosure statement is set forth in the CFTC's rules.

For commodity options, CFTC rules require that FCMs provide to customers a commodity options risk disclosure statement. Like the futures statement, this statement discusses commodity options generically and the text of the statement is set forth in the CFTC's rules. The commodity options disclosure statement includes a description of commodity options and discussions of the mechanics of options trading, margin requirements, the profit potential of an options position and the risks of options trading.

In addition to dissemination of the risk disclosure statement, the CFTC's commodity options rules prohibit an FCM from opening a commodity options account for a customer unless the FCM has provided the customer "with a degree of disclosure and explanation concerning the risks inherent in options trading appropriate to the personal circumstances of the customer." The FCM is required to use due diligence to inquire, consider and make a record of the customer's financial conditions, investment objectives and market sophistication.

OPTIONS	FUTURES

4. Supervision

The options SROs require (i) that member firms develop and implement a written program for the supervision of their options business; (ii) that those options programs be under the overall supervision of a designated senior registered options principal; (iii) that compliance responsibilities be under the supervision of a designated compliance registered options principal; and (iv) that all branch offices (except those with less than three options representatives) be supervised by a principal-qualified branch office manager.

Exchange rules on GNMA and Treasury options essentially require the adoption of a parallel supervisory structure, with the responsibility for supervising trading in those options resting with persons specifically qualified with respect to those options. A similar system has been proposed for foreign currency options (with the exception that branch office managers need not be foreign currency option qualified).

CFTC rules impose a general requirement that FCMs must diligently supervise the handling of all firm futures activities. While this provision does not impose any specific supervisory requirements, the CFTC's rules require that FCMs trading commodity options must adopt and enforce written supervisory procedures enabling them to supervise adequately each public customer's options account.

OPTIONS	FUTURES

5. Advertisement and Sales Literature

The rules of the options SROs establish detailed standards concerning the content and manner or presentation of options advertisements and sales literature. All advertisements and sales literature (except completed worksheets) must be approved in advance by a firm's Compliance Registered Options Principal. Broker-dealers also are required to submit advertisements to options SROs for approval or review prior to use.

The CFTC relies on its general anti-fraud rules to regulate futures advertisements by FCMs. CFTC regulations for commodity pool operators and commodity trading advisers specifically prohibit them from advertising in a manner which is false, misleading or deceptive, and the CFTC has issued a release providing guidance as to the types of advertisements prohibited by this rule. Some boards of trade specifically regulate advertisements, although none require prior approval or review of advertisements by a firm officer or supervisor; nor do they regulate sales literature.

The CFTC's commodity options rules contain more rigorous provisions governing commodity options "promotional materials," including a provision that boards of trade require that all promotional materials be submitted by member FCMs to the boards of trade and promptly reviewed by them. The commodity options rules also prohibit fraudulent or "high-pressure" sales communications by FCMs.

6. Testing

The options SROs require that all registered representatives pass a general securities examination that includes options questions. Options supervisors must pass a general principal examination plus a separate options principal examination. Persons selling, or supervising the sale of, options on debt securities must pass a separate interest rate options examination. Proposed exchange foreign currency options rules also would require separate testing with respect to those options.

The CFTC does not require associated persons of FCMs to pass qualifying examinations relating either to futures or options on futures in order to market those instruments to the public. We understand that 4 of the 11 boards of trade require associated persons of member firms to pass a general futures examination administered by the Futures Industry Association. Additional examination requirements are not imposed on supervisory personnel, or on persons marketing financial futures.

OPTIONS	FUTURES

7. Safekeeping of Customer Funds

Commission rules require that funds deposited by customers must be segregated from a broker-dealer's own funds. Margin deposits made by one customer, however, may be loaned out by a broker-dealer to other customers.

The Commodity Exchange Act requires FCMs to "separately account for" (or segregate) the funds deposited by each customer. Those funds cannot be comingled with the funds of the FCM, and may not be used for any purpose other than to cover the trading obligations of the particular customer for whom they were deposited.

B. Surveillance and Regulatory Restrictions on Manipulation

1. Surveillance Information Sharing Between . . .

a. Options and Futures Exchanges Trading Options on Futures on the Same Underlying Instruments

Currently there are no instances in which options and futures exchanges are trading derivative contracts on the same underlying instruments, although the Commission has received several proposals to trade options on instruments on which futures now are traded (GNMAs, Treasury bills, notes and bonds, certificates of deposit, foreign currency and stock indices). The Commission would have clear authority to permit trading of these options under the proposed legislation.

The Commodity Exchange Act permits the CFTC to exchange surveillance information with the Commission but not with the securities exchanges; nor does it allow the Commission to pass on information received from the CFTC to the exchanges. These restrictions would be eliminated by the proposed legislation. In addition, a commitment has been made by two commodity exchanges, the CBT in writing and NYFE orally, to cooperate in exchanging surveillance information with any securities exchange authorized to trade options on a stock index on which they trade a futures contract.

OPTIONS	FUTURES

b. Futures Exchanges Trading a Stock Aggregate and the Primary Stock Exchange for the Underlying Securities

In addition to the commodity exchange commitments discussed above, NYFE and the NYSE informally have indicated that, as a condition to the trading of futures contracts on three NYSE sector indices (the NYSE Industrial, Utilities and Finance Indices), NYSE would be willing to make available to the NYSE all of the surveillance information it collects on the sector index futures contracts, and NYSE has indicated it would be willing to make available to NYFE its surveillance information on the underlying securities.

2. Audit Trail

The options exchanges have been required by the Commission, and have in place, audit trails designed to permit the exchange to ascertain complete information about each options transaction effected on the exchange, including the time, price and size of the transaction and the floor brokers and clearing firms on each side of the trade.

Since reporting of each transaction is not required by the CFTC or boards of trade (with the exception of NYFE), the boards of trade lack the data necessary to construct a complete audit trail. Since to-the-minute information is received concerning the time customer orders are sent to and returned from the trading floor, it may be possible under limited circumstances to determine the relative time customer and firm orders were executed.

OPTIONS	FUTURES

3. Speculative/Position Limits

The options exchange, at the Commission's direction, have imposed a proposed position and exercise limit on each of the options contracts they trade or are seeking authority to trade. The position limits apply to the aggregate position on either side of the market (i.e., long calls plus short puts or vice versa) and there is no netting of hedged or spread positions. Exercise limits refer to the total number of puts or calls that can be exercised in any five business day period. Position and exercise limits are as follows:

Stock Options - 2,000 contracts

GNMA Options - 2,000 contracts ($200 million principal amount)

Treasury Note and Bond Options - 1,000-2,000 contracts ($100-200 million principal amount)

Treasury Bill Options - 250-500 contracts ($250-500 million principal amount)

Foreign Currency Options - 10,000 contracts (proposed) (approximately $3 billion principal amount)

Stock Group Options - 2,000 contracts (proposed)

Stock Index Options - 40,000 contracts (proposed) (approximately $2.5 billion principal amount)

The boards of trade have not in the past had speculative limits applicable to financial futures. However, the CFTC recently required them to establish speculative limits for all futures contracts and options on futures contracts. The limits apply only to that portion of a participant's position that is unhedged (i.e., not covered by an opposite futures contract or by a position in the underlying commodity). Speculative limits have been proposed at the following levels for financial futures:

GNMA Futures - 5,000 contracts ($500 million principal amount)

Treasury Bond Futures - 10,000 contracts ($1 billion principal amount)

Treasury Note Futures - 10,000 contracts ($1 billion principal amount)

Treasury Bill Futures - 15,000 contracts ($15 billion principal amount) reduced to 1,000 contracts ($1 billion) the week before delivery

The boards of trade have adopted, and the CFTC has approved, speculative limits of 2,000 to 5,000 contracts for stock index futures (approximately $1.2 to $3 billion principal amount).

OPTIONS	FUTURES

II. Substantial Regulatory Differences Which Would Require Congressional Action to Pursue

A. Enforcement and Customer Remedies

1. Enforcement Remedies

a. Civil Penalties

The Commission may enjoin, suspend or impose similar sanctions on broker-dealers and their associated persons and securities exchanges. The Commission lacks the power, however, to impose fines against such persons. The securities exchanges possess the power to fine member firms and their associated persons, as well as pursue injunctive actions, for violations of the federal securities laws and exchange rules.

In addition to injunctive power, the CFTC has the power to levy fines of up to $100,000 against any person, including FCMs, their associated persons, and boards of trade. The boards of trade may fine or enjoin member firms and their associated persons.

b. Standard of Proof

The Supreme Court has held that scienter must be established to sustain a private fraud action under the federal securities laws (Ernst & Ernst v. Hockfelder). It has been held that recklessness or an extreme departure from the standard of ordinary care satisfies this requirement (Aaron v. SEC; Sunstrand Corp. v. Sun Chemical).

The CFTC has interpreted its general antifraud provision to encompass constructive fraud by a fiduciary and thereby to omit intent as an element of a violation. While the 9th Circuit has held that there is a knowledge requirement, it held that this requirement could be satisfied by proof of carelessness. Moreover, the provisions applicable to commodity options, pools and advisers contain no reference to willfulness and arguably do not require intent to defraud.

OPTIONS	FUTURES

2. Customer Remedies

a. Availability of Private Rights of Action

Several provisions of the federal securities laws grant investors express causes of action against securities professionals and others. In addition, rights of action also have been implied by the courts under other provisions, particularly Section 10(b) of the Securities Exchange Act and Rule 10b-5 thereunder, although implied causes of action have been held not to exist under other provisions of the federal securities laws. Investors may also pursue remedies under state general anti-fraud statutes as well as state "blue sky laws."

The Supreme Court recently held that purchasers and sellers of futures contracts have implied rights of action under several sections of the Commodity Exchange Act, including the anti-fraud provisions. In addition, some courts have held that futures customers may have remedies under the anti-fraud provisions of the federal securities laws. Investors may pursue remedies under general state anti-fraud laws, but not blue sky laws or other laws relating specifically to futures.

b. Reparations/Customer Arbitration

There is no reparations procedure under the federal securities laws similar to that established under the Commodity Exchange Act. The securities SROs, however, have established uniform arbitration procedures for the handling of investor grievances against broker-dealers. There is no ceiling on the size of claim that can be arbitrated, although special streamlined procedures have been adopted for claims less than $2,500.

The CFTC has a unique reparations procedure, in which aggrieved futures customers may file claims for damages against FCMs based on violations of the Commodity Exchange Act. Certain of the boards of trade also have arbitration procedures; the proposed CFTC reauthorization legislation would remove a $15,000 ceiling on claims eligible for arbitration.

OPTIONS	FUTURES

B. Public Interest Standard--CFTC Economic Purpose Test

In order to approve new options product proposals (or other SRO rule filings), the Commission must find affirmatively that the proposal is in the "public interest." While the Commission has not adopted an explicit "economic purpose" test under this provision, the staff has carefully examined the economic utility of new options products in considering exchange proposals to trade them.

Section 5(g) of the Commodity Exchange Act requires that a board of trade demonstrate that trading in a futures contract not be contrary to the "public interest" in order to be designated to trade that contract. Under this standard, the CFTC has adopted an "economic purpose" test: a contract either must serve a price discovery or a hedging function.

C. Emergency Powers

The Commission is given the authority under Sections 12(j) and (k) of the Exchange Act to suspend the registration of any security. While the Commission does not have explicit additional emergency powers, several sections of the Exchange Act confer broad rulemaking authority on the Commission, particularly Section 9(b) in connection with options trading. A rule was proposed by the Commission under Rule 9(b) at the outset of the options moratorium, but was not adopted being the exchanges voluntarily agreed to the moratorium.

Section 8(a)(9) of the Commodity Exchange act vests the CFTC with braod powers to act in any market emergency. The exercise of those powers have been held to be non-reviewable by the 7th Circuit. The proposed CFTC reauthorization legislation would provide a narrow right of judicial review. It also would clarify the CFTC's authority to set temporary emergency margin levels and position limits.

OPTIONS	FUTURES
D. SIPC (Protection Against Broker Insolvency)	
In the securities market, the Securities Investor Protection Act ("SIPA") provides protection of broker-dealers that are forced to liquidate. Currently, the limits of protection are $500,000 per customer, of which $100,000 may be claims for cash. Options customers are entitled to SIPA protection.	Customers trading futures and options on futures are not entitled to SIPA or any similar protection, even if the FCM is also a registered broker-dealer. Before enactment of the legislation creating the CFTC in 1974, Congress considered commodity account "insurance," but instead directed the CFTC to study the matter. In 1976, the CFTC concluded the need for insurance was low because (1) public confidence in the safety of customer funds was high and (2) insurance would not be cost-effective.
E. Margin	
1. Authority	
The Federal Reserve Board and SEC have pervasive authority to establish and enforce margin standards for securities options.	Under the Commodity Exchange Act, the CFTC is not permitted to review the futures margin requirements of the boards of trade. The Federal Reserve Board has asserted its authority to establish margins with respect to futures on securities indices (although it has not yet sought to exercise that authority). For options on futures, the CFTC has adopted rules setting forth certain margin requirements and giving it the authority to review board of trade margin proposals.

OPTIONS	FUTURES

2. Initial Margin

Purchasers must pay 100% of premium (i.e., options have no loan value in a margin account). Uncovered writers (analogous to both futures sellers and purchasers) must post the following margin:

Stock options--30% of market value of underlying securities.

Debt security options--Since the margin is premium-based, precise percentage levels cannot be stated. However, as a general matter, this will put margin for debt securities roughly in the range from 5% for Treasury bond and GNMA options to 0.5% for 13-week Treasury bill options.

GNMA options--130% of options premium plus $1,500 minus the amount the contract is out-of-the-money.

Treasury bond options--100% of premium plus $3,500

Treasury note options--100% of premium plus $2,000-$3,000.

Treasury bill options--100% of premium plus $3,500-$7,500.

Stock group options--30% of value of underlying securities.

Index options--10% of value of contract (proposed).

Foreign currency options--130% of premium plus $750 minus the amount the contract is out-of-the-money.

Purchasers and sellers are subject to the same margin. Futures margin deposits generally range from 2% to 10% of the value of the contract, with margin for hedgers somewhat less than margin for speculators. Below are margin requirements for the principal financial futures contracts:

GNMA and Treasury bill, note and bond futures--$2,000 (speculators), $1,500 (hedgers). (Thus, speculative margin would range from 2% for Treasury bond and GNMA futures to 0.2% for Treasury bill futures.)

Stock index futures--speculative margins of approximately 10%, hedger margins of approximately 5%.

Foreign currency futures--between $900 and $2,000 (for speculators), depending on the particular currency underlying the futures contract.

III. Clarification of Areas Where Financial Futures and Options Regulation Are Comparable but Differ From Stock Regulation

For both options and futures, once a transaction is cleared, any relationship between the two parties to the transaction is severed and a clearing corporation is interposed (for all listed options in the U.S., the clearing agency is the OCC; for futures each board of trade has a separate clearing affiliate). That is, once an investor has purchased an option or a future, he does not look to the other party to the transaction for performance in the event he exercises the option or takes delivery on the future. Instead, he looks to the clearing corporation for performance (which in term would assign his options exercise or futures contract delivery to an options writer or futures seller). Each options and futures clearing corporation maintains a clearing fund so that it is able to guarangee delivery of options on futures contracts upon their exercise or maturity.

This procedure is an essential ingredient to a liquid secondary market for options and futures. It enables all market participants to trade without regard to the credit-worthiness of the party on the other side of the transaction (who normally is unknown to him) and thus is crucial to public confidence in the market.