

heters

The Honorable John D. Dingell
Chairman
Committee on Energy and Commerce
House of Representatives
Washington, D.C. 20510

Dear Mr. Chairman:

I am responding to your letter of July 15, 1982, regarding the rules proposed by the CFTC (47 FR 28401 (June 30, 1981)) to permit the trading of options on "physicals." In this regard, I am enclosing a memorandum prepared by the Commission staff which discusses the proposed rules to expand the CFTC options pilot program in view of the current provisions of the Commodity Exchange Act (the "CEA") and the suggested amendments to the CEA as embodied in the SEC/CFTC Accord.

I hope this information will be helpful to you. If we can be of further assistance, please do not hesitate to contact me or Richard Ketchum, Associate Director of the Division of Market Regulation at 272-2866.

Sincerely,

John S.R. Shad
Chairman

Enclosure

M E M O R A N D U M

TO: Chairman Shad

FROM: Division of Market Regulation
Office of the General Counsel

SUBJECT: Response to Congressman Dingell
regarding proposed CFTC definition
of physical

This memorandum has been prepared in response to the letter of July 15, 1982 from The Honorable John D. Dingell, Chairman of the House Committee on Energy and Commerce. Chairman Dingell has inquired about proposed Commodity Futures Trading Commission ("CFTC") rules to implement a pilot program for the trading by commodities exchanges of options on physicals. Among other things, the proposed rules contain a broad definition of the term "physical."

The SEC/CFTC Accord, as contained in part in the amendments to the Commodity Exchange Act ("CEA") in H.R. 5447, would prohibit the CFTC from authorizing trading of options on physicals where the underlying instruments are securities. In particular, H.R. 5447 would amend Section 2(a)(1) of the CEA to state that:

This Act shall not apply to and the Commission shall have no jurisdiction to designate a board of trade as a contract market for any transaction whereby any party to such transaction acquires any put, call or other option on one or more securities (as defined in section 2(1) of the Securities Act of 1933 or section 3(a)(10) of the Securities Exchange Act of 1934 on the effective date of Public Law _____), including any group or index of such securities, or any interest therein or based on the value thereof.

Thus, although CFTC's proposed definitions of "physical" and "commodity option transaction" in connection with its options on physicals pilot program (as proposed in Section 1.3(11) and revised paragraph (hh), 47 FR 28403, June 30, 1982), are broad, the Accord expressly proscribes the CFTC from approving options based on instruments which the Commission currently regulates. Accordingly, the proposed expansion of the CFTC's commodity options pilot program to encompass options on physicals will not have any effect on the cash market for any security under the Commission's jurisdiction.

Moreover, under the terms of the Accord, the CFTC would be unable, with one exception, to approve trading of options on physicals with respect to any instrument on which the Commission also could approve options trading. Accordingly, for the most part, the CFTC's proposed options on physicals pilot program would not involve options markets that were related to any options markets within the Commission's jurisdictional responsibilities. The one exception concerns options on foreign currency. Under the Accord as embodied in H.R. 5447, the CFTC would be authorized in the proposed options on physicals pilot program to designate a board of trade as a contract market for options on foreign currency. Concomitantly, H.R. 6156, in effectuating the Accord, would authorize the Commission to approve the trading of options on foreign currency on a national securities exchange.

As a consequence, the Accord contemplates the possibility that the CFTC and the Commission each could authorize the trading of options on foreign currency physicals on their respective regulated exchanges. This possibility raises potential concerns about the comparative regulatory structures under which the respective markets might operate. The staff continues to believe that functionally similar investment instruments should compete on the basis of economic utility. ___/ In our view, regulatory disparities have potentially adverse consequences on the developments of markets of functionally similar investment instruments. Because the proposed expansion to the CFTC options pilot program would allow the development of competing foreign currency options markets, we believe that the Commission should monitor closely foreign currency options trading to identify whether existing regulatory differences result in significant investor confusion or adversely affect the development of those markets.

___/ See letter from Edward F. Greene, General Counsel, SEC, to the Honorable Timothy E. Wirth, Attachment at 21 (dated May 21, 1982).