M E M O R A N D U M

August 27, 1982

TO: Douglas Scarff

FROM: Richard Ketchum RK

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." Specifically, Chairman Dingell asked for comments with respect to problems arising from regulatory disparities, the level of investor and market protections, and the breadth of the new definition of the term "physical."

With respect to the latter, we believe that it is important to note that the coverage of the term "physical" is limited by provisions of the SEC/CFTC Accord. The 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, or indices or groups of securities. 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(ll) 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 could approve options trading. Accordingly, for the most part, the CFTC's proposed options on physicals pilot program would not involve options markets related to any options markets within the Commission's jursidictional 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. 1/ 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.

Finally, we note that it is possible that exchanges that currently are registered as securities exchanges with the Commission may seek designation as contract markets under the CFTC's proposed options on physicals pilot program. 2/ Such a securities exchange initiative would not be without precedent. In the past, two securities exchanges, the American and New York Stock Exchanges, have established affiliates for the purpose of trading commodity futures contracts. Each of these futures markets was organized as a separate corporate entity with a separate membership. In neither instance did the establishment of a futures market result in a reduced commitment by the exchange to its securities market; nor did its existence have any adverse effect on the regulation of the exchange's securities activities. In addition, we do not believe that the establishment of these

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

2/ Unlike the CFTC's current options on futures pilot program, designation as a contract market for futures on a commodity is not a prerequisite to designation to trade the related options contracts.

futures markets in any way reduced public confidence in the integrity of the security markets. In the event a securities exchange sought CFTC designation as a contract market for options on physicals, we believe similar protections would be introduced to ensure that the exchange's securities market was not adversely affected.