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Committee on Commodities Regulation
ABA Section of Corporation, Banking and Business Law

Douglas Scarff
Director, Division of Market Regulation
Securities and Exchange Commission

I. SEC-CFTC Jurisdiction Accord

A. Review of Accord Provisions

Under the terms of the SEC-CFTC Jurisdictional Accord, the two agencies agreed to clarify their respective regulatory responsibilities and sought to codify that agreement formally. Among other things, the Accord clarified that the SEC has jurisdiction over put and call options on exempt and non-exempt securities, certificates of deposit, groups or indices of securities, and, when traded on a national securities exchange, foreign currency. It also clarified that the CFTC has jurisdiction over futures contracts on exempt securities, certificates of deposit and broad-based indices of securities, as well as over options on these futures, and over options on foreign currencies traded on a commodities exchange.

The Accord was introduced in Congress in two separate sets of legislation: the amendments to the securities laws were contained in H.R. 6156 and S. 2260, while the amendments to the Commodity Exchange Act ("CEA") were coupled with CFTC reauthorization and contained in H.R. 5447 and S. 2109. The Securities Acts Amendments of 1982 were passed by the House on September 23, 1982 and by the Senate on October 1, 1982 and signed by the President on October 13, 1982. The commodities portion of the Accord was coupled with CFTC reauthorization and as the date of this outline, was awaiting resolution by Congress after being passed in different versions by the House and Senate.

B. Stock Index Futures

Under the terms of the Accord, the CFTC may authorize trading in a stock index futures contract (or an option on a stock index futures contract) if, in addition to the usual CEA criteria, the following conditions are met: (1) the index is settled in cash or exempted securities, (2) trading in the contract is not readily susceptible to manipulation in the price of the contract or of underlying securities included in the index, and (3) the index is a widely published measure of and reflects the market for all publicly traded equity or debt securities or a substantial segment thereof or comparable to such measure.

1. Pursuant to this provision, the CFTC after receiving and considering comment from the SEC has approved the following indices for trading:

- (a) Kansas City Board of Trade -
Value Line Average (February 16, 1982)
- (b) Chicago Mercantile Exchange -
Standard & Poor's 500 (April 20, 1982)
- * (c) Commodity Exchange, Inc. -
Standard & Poor's 500 (April 28, 1982)
- (d) New York Futures Exchange -
New York Stock Exchange Composite Index
(May 11, 1982)
- * (e) Chicago Board of Trade -
Dow Jones Industrial Average (May 11, 1982)
- (f) New York Futures Exchange -
New York Stock Exchange Indices: Industrial,
Financial, Utility (September 21, 1982)

The Commission, in evaluating whether these products met the Accord standards has considered the following factors: (1) the number of securities contained in the index or group; (2) the capitalization of those securities, (3) the depth and liquidity of the secondary market for those securities; (4) the diversification of the group or index; and (5) whether the group or index is weighted.

2. A number of stock index futures proposals are currently pending before the CFTC. The SEC expects to comment to the CFTC on whether, in the SEC's view, they meet the terms of the Accord.

- (a) The Chicago Board of Trade proposes to trade a futures contract based on an "Industry Composite Portfolio," revising the earlier CBT stock index futures proposal to trade a futures contract based on the Dow Jones Industrial Average.
- (b) The Chicago Mercantile Exchange proposes to trade futures contracts based on six Standard & Poor's sub-indices.
- (c) The New York Futures Exchange proposes to trade a futures contract based on a NYSE newly-created Energy Index.

* Not trading due to lawsuits by the developers of the indices.

3. The SEC/CFTC Accord would provide that the CFTC must consult with the SEC before acting on a securities index futures proposal (and over the past year the two agencies have acted consistent with the terms of the Accord.) The House passed version of the commodities portion of the Accord (but not the Senate version) however, would give the SEC veto power over approval of stock index futures contracts. The SEC's position (in Chairman Shad's testimony before Congress) is that the Accord should be enacted in the manner agreed upon by the two agencies.

II. SEC-CFTC Regulatory Differences

A. Regulatory Structure

Both the SEC and the CFTC rely to a certain extent upon self-regulation by the industry, although the securities laws place substantially greater emphasis on the SEC's oversight responsibilities while the CFTC maintains more direct responsibility for surveillance of market activity. Primary areas of regulatory difference are customer protection rules, margin, surveillance capability and regulatory restrictions on manipulation.

Customer Protection Rules

1. Suitability

The rules of the options exchanges (the American Stock Exchange ("Amex"), Chicago Board Options Exchange ("CBOE"), Pacific Stock Exchange ("PSE") and Philadelphia Stock Exchange ("Phlx")), the National Association of Securities Dealers ("NASD"), the New York Stock Exchange ("NYSE") and Midwest Stock Exchange ("MSE") (collectively, the "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. 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 or she can be expected to be capable of evaluating and financially can bear, the risks of the transaction. These rules apply to all options transactions including transactions in options on exempted securities, stock indices and foreign currency.

CFTC rules require that futures commission merchants ("FCMs") provide certain oral disclosures concerning commodity options at the time they open a customer's options account that are tailored to the personal circumstances of the

customer. There are no provisions in the CFTC or boards of trade rules governing the suitability of recommended transactions in futures or options on futures.

2. 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. 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 customers who are natural persons 15 specific categories of information, such as investment objectives, income, net worth and investment experience. Account approval must be in writing and can be made only by a qualified branch office manager or other supervisor. In addition, exchange rules also require separate account approval before a customer may trade options on debt securities or options on foreign currency (whether or not the customer's account already is approved for trading stock options).

Before opening a customer commodity options account, a futures commission merchant must make certain disclosures to a customer and make an investigation of the customer's financial condition, objectives 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. Although the CFTC and the boards of trade do not impose similar restrictions or requirements on the opening of futures accounts, some firms impose voluntary requirements as to net worth and other matters before opening a customer's account.

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, an Options Disclosure Document that discusses in non-technical terms the risks and uses of options trading; the terms of options; the mechanics of buying, writing and exercising options; and transaction costs, margin requirements and tax consequences of options trading. Supplemental disclosure documents are given to investors before they trade in options on debt securities, foreign currency or stock indices.

Disclosure about futures is provided to customers in a brief document that discusses generically the risks and characteristics of futures. For commodity options, CFTC

rules require that FCMs provide to customers a written commodity options risk disclosure statement. The text of the disclosure statement is set forth in the rule and includes a description of commodity options, the mechanics of options trading, margin requirements, the profit potential of an options position, and the risks of options trading. With respect to commodity options, the rule relies on the FCM to provide most details concerning particular options contracts.

In addition to dissemination of the risk disclosure statement, the CFTC's commodity option 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." This provision requires the FCM to use due diligence to inquire, consider and make a record of the customer's financial conditions, investment objectives and market sophistication.

4. Advertisements and Sales Literature

The rules of the options SROs establish detailed standards concerning the content and manner of 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 and advertisements must be submitted to an exchange or the NASD for approval or review prior to use.

The CFTC relies on its general anti-fraud rules to regulate the FCM futures advertisements of FCM relating to futures trading. Some boards of trade specifically regulate advertisements, although none require prior approval of advertisements by a firm officer or supervisor, nor do they include the regulation of sales literature.

The CFTC's commodity options rules contain more rigorous provisions governing commodity options promotional materials, including a provision that boards of trade rules require that all promotional materials be submitted by 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 with respect to commodity options.

5. Qualification Requirements

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. In addition, Phlx has established a requirement that persons selling, or supervising the sale of, foreign currency options take a separate qualification examination. The exchanges proposing to trade options on stock groups or stock indices have not proposed to require successful completion of a separate test covering these subjects, but instead would propose to include questions on those contracts in the current qualification examinations relating to stock options.

Some boards of trade require FCM associated persons to pass qualifying examinations. The CFTC does not require that associated persons of FCMs pass a qualification examination relating either to futures or to options on futures in order to market those instruments to the public.

6. 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 regarding options on exempted securities essentially require the adoption of a parallel supervisory structure with respect to such options, with the responsibility for supervising trading in such options resting with persons who are qualified specifically with respect to exempted securities options trading. A similar system has been proposed with respect to foreign currency options, with the exception that all 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 specific supervisory requirements, the CFTC's commodity options rules require that FCMs trading commodity options must adopt and enforce written supervisory procedures that will enable the firm to supervise adequately each public customer's options account.

7. Liquidation of Firms

In the securities markets, the Securities Investor Protection Act ("SIPA") provides protection for customers of broker-dealers that are forced to liquidate. Customers trading securities options, including options on exempted securities, stock indices and foreign currency, would receive these protections. Customers trading futures contracts and options on futures, do not receive the protections of the SIPA if an FCM were forced to liquidate (even if the FCM is also registered as a broker-dealer), since such contracts are not "securities" for purposes of SIPA.

8. Segregation of Customer Funds

SEC rules provide 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 CEA, on the other hand, requires FCM's to "separately account for" or segregate 100 percent of funds deposited by each customer. Those funds cannot be comingled with the funds of the FCM, and may not be used for any purposes other than to cover the trading obligations of the particular customer for whom they were deposited.

9. at Margin 1. Margin Requirements

The Federal Reserve Board and the SEC have pervasive authority to establish and enforce margin standards for options on securities and new options products. Purchasers of options must pay 100 percent of the premium (i.e., options have no value in a margin account). Uncovered writers must post 30 percent of the value of the underlying securities with respect to stock options. With respect to new products, margins are premium based and writers must post margin in an amount sufficient to cover the expected price movements of the underlying instruments. Options margin for new products short positions ranges from 0.5 percent to 10 percent. In addition, both with respect to equity options and new option products, the options SROs and the Options Clearing Corporation have maintenance margin requirements.

Margin is not covered required for short call position covered by a long position in the underlying security.

Under the CEA, 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, but has not yet exercised that authority. For options on futures, the CFTC has adopted rules setting forth certain margin

2. Covered Options Writing

Margin is not required for covered writing positions. In equity options, a short call position is only considered covered where the writer has a long position in the underlying security. Covered may mean receipt of letter of guarantee for those securities (bank deposit in an account). The margin rules approved for debt options continued this basic approach although these rules did define an investor as covered for purposes of writing Treasury and Options where he deposited Treasury Bonds in his account which had a maturity of less than 90 days to maturity than Bonds eligible for delivery. Philo, however, has proposed (although the Commission has not yet approved) a definition of bank's own margin requirement.

requirements and giving it the authority to review board of trade margin proposals. Futures margin deposit generally range from 2 percent to 10 percent of the value of the contract, with margin for hedgers somewhat less than margin for speculators. For example, stock index futures margin for speculators is approximately 9 percent, with hedgers margin about one-half that. Open futures positions are marked-to-market daily. Persons with open positions that have moved away from the market generally are required to post additional margin the following business day.

Although the purpose of commodities margin may have originally differed from securities margin, to the extent market participants may now speculate on the movement of the market through a minimum investment, it appears that concerns such as controlling excessive use of credit, ensuring broker-dealer financial stability and protecting customers from becoming over-extended may become appropriate. In this regard, the Federal Reserve System is currently conducting a margin study, and Section 237 of H.R. 5447 would establish a study to examine the effect on the economy of the "trading of futures and related instruments, such as options."

Floor Trading Rules

For the most part, the trading crowds for most issues of common stock have not been large (in fact, in many instances there has been no trading crowds at all). As a result, the securities exchanges in connection with their surveillance of trading activity adopted rules requiring that all orders be stamped as to the time of execution.

When exchange trading of options was introduced, the manipulation concerns that were raised caused the Commission to require that floor trading rules, such as the time-stamping of transaction reports, be carried forward into the options markets, despite the multiplicity of options series traded in a particular options class and the presence of sizable trading crowds. In fact, in certain respects, such as the development of complete audit trails, evolution of the standardized options markets has outpaced developments in the equity markets.

In contrast to the securities markets, trading in futures contracts traditionally has been limited to a smaller number of contracts for which there often have been large trading crowds, sometimes including 100 or more traders. In this context, it has been argued that recording and contemporaneous time-stamping of each order is not technically feasible.

10. Dual Trading

The options exchanges prohibit floor traders (with the exception of the specialists on the two options exchanges employing a specialist system) from acting as both broker and dealer in the same options class on the same day. The purpose of this rule is to avoid self-preferment or other conflicts of interest on the part of floor traders.

Section 4j(1) of the CEA gives the CFTC the express authority to consider whether to prohibit a floor broker from trading for his own account and also executing a customer's order. Rather than adopt a blanket prohibition against dual trading, the CFTC has adopted rules that prohibit a floor broker from trading for his own account while holding a customer order executable at the current market price. This rule also would apply to trading in commodity options.

11. Time-Stamping and Reporting of Orders

The options exchanges require that all order tickets be time-stamped immediately upon execution. Transactions also must be reported immediately to floor reporters for entry into the exchanges' transaction reporting system and for transmission to and dissemination by the Options Price Reporting Authority ("OPRA"). Both the price and size of all options transactions are reported and disseminated. This has permitted development by the options exchanges of a complete audit trail, which facilitated the detection and prevention not only of intra-market floor trading rule violations, but also of inter-market manipulations involving that options market, any other options market trading the same options class, and the market(s) for the underlying security.

The CFTC has proposed, but never adopted, to-the-minute time-stamping of all futures trades. A similar rule also was considered for commodity options but never adopted. The CFTC, instead, requires that futures and commodity options transactions be recorded by floor traders within 30 minute time segments. The CFTC does require, however, that customer orders be time-stamped to the nearest minute upon receipt on the floor by a floor broker and again to the nearest minute upon execution. While these requirements may facilitate identification of self-preferment and other trading abuses by floor traders, they do not permit creation of an audit trail.

B. Impact of Regulatory Differences Upon Trading Markets

In the last several years, the products regulated by the two Commission's have moved closer together. At this

time, the SEC has authorized, or trading has begun, in options on Treasury bills, bonds, and notes, GNMA's, CD's, foreign currency and stock indices. Futures contracts are currently traded on all of these products and options on Treasury bond futures have been trading for several months. As the industries gain experience in the trading of these new products, the need to develop a comparable regulatory structure for both industries will become more urgent. In this regard, it should be noted that the CFTC has recently proposed expanding its individualized disclosure rules with respect to commodity options to also cover futures.

III. Insider Trading

A. Securities Laws

The Commission's regulation of trading in the securities markets is predicated on the basis that complete disclosure of material facts must be made by insiders prior to their trading of the basis of this information.

1. This concept has been developed in connection with the trading of stock. SEC v. Texas Gulf Sulfur Co., 401 F.2d 833 (2nd Cir.), cert denied sub nom. Coates v. SEC, 394 U.S. 976 (1976). See also Newman v. United States, 644 F.2d 12 (2nd Cir. 1982). (Securities laws violated when investment banking firms' employees misappropriated their employers confidential information and traded on the basis of that information.)

2. The Second Circuit recently held that a private right of action exists under both Rule 10b-5 and Rule 14e-3 for options writers when the purchasers of the options bought on the basis of material, inside information about a tender offer growing out of the Socal bid for Amax. O'Connor & Associates v. Dean Witter Reynolds, Inc., 529 F.Supp. 1179 (S.D.N.Y. 1981).

(a) The O'Connor court rejected defendants' claims that after the Supreme Court's decision in Chiarella v. United States, 445 U.S. 222 (1980), insiders could not be liable under Rule 10b-5 to options writers, holding that options writers have standing to sue for damages for defendant's breaches of fiduciary duties owed to other persons.

(b) The O'Connor court also allowed a private right of action to proceed under Section 14(e) and Rule 14e-3 because substantial steps were taken toward commencement of a tender offer. The court found that Rule 14e-3 prohibited insider trading of this nature.

3. The Commission believes that extending the prohibitions against insider trading to cover options is necessary because they ensure investor confidence in the integrity of the markets and make professionals willing to risk capital in making markets in securities.

B. Commodities Laws

Unlike the securities laws, the commodities laws do not establish prohibitions against insider trading. Rather, Chairman Johnson of the CFTC has testified before Congress that there is no need for insider trading restrictions because through the use of "inside information" the boards of trade operate as efficient pricing mechanisms. As the CFTC authorizes these boards of trade to operate markets on financial futures, including futures on stock indices, however, it becomes increasingly important that prohibitions be established to ensure that futures trading is not used to disrupt or manipulate the underlying markets for securities of the options markets. Similarly, it would appear appropriate to also prevent persons with insider information to refrain from trading in stock indices until that information is publicly available. In this regard, S. 2109 provides for a study by the CFTC of the extent of insider trading of futures contracts.