



COMMODITY FUTURES TRADING COMMISSION

2033 K STREET, N.W., WASHINGTON, D.C. 20581

(202) 254-6970

(202) 254-6265 FACSIMILE

710-822-9327 TELEX

OFFICE OF
THE CHAIRMAN

May 16, 1989

The Honorable Patrick Leahy
The Honorable Richard Lugar
Committee on Agriculture, Nutrition
and Forestry
United States Senate
Washington, D.C. 20510-6000

Dear Senators Leahy and Lugar:

Thank you for your letter of April 10, 1989 in which you posed three questions regarding the approval by the Securities and Exchange Commission ("SEC") of the proposals submitted by the Philadelphia Stock Exchange, American Stock Exchange and the Chicago Board Options Exchange to trade index participations ("IPs"). We appreciate this opportunity to present our views.

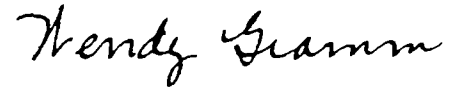
The attached document contains the answers to your questions. The answer to the first question sets forth our view that trading of IPs constitutes trading of futures contracts rather than securities as defined in the Securities Exchange Act of 1934. Specifically, the 1982 amendments to the securities laws and the Commodity Exchange Act, which codified the Johnson-Shad Accord, confirm that the CFTC has exclusive jurisdiction over trading in futures contracts (and options on futures contracts) "on a group or index of securities (or any interest therein or based in the value thereof)." Since IPs are futures contracts on stock indexes, the CFTC has jurisdiction over them.

In answer to the second question, we have set forth the steps that the CFTC has taken to resolve these jurisdictional issues with the SEC. It is not our intent to engage in "turf battles" or encourage litigation. To the contrary, by commenting during the public comment period and engaging in dialogue with the SEC, we have hoped to avoid the kind of litigation that occurred in 1981. In fact, at its March 14, 1989 open meeting, the SEC noted the cooperative efforts of the two agencies.

Finally, in answer to the third question, we have described the issues involved in the Commission's designation process and regulatory scheme as they would apply to IPs.

We hope this answers your questions. Please let us know if you would like any further information. I would be happy to meet with you at your convenience to discuss this matter.

Sincerely,

A handwritten signature in cursive script that reads "Wendy L. Gramm".

Wendy L. Gramm
Chairman

Attachments

Question No. 1: Why does the CFTC consider index participations to be futures contracts and specifically not (a) securities, (b) forward contracts, (c) permissible hybrids under relevant Federal Register releases, or (d) some other miscellaneous instrument?

A. DESCRIPTION OF INDEX PARTICIPATIONS

The Philadelphia Stock Exchange, Inc. ("PHLX"), the American Stock Exchange, Inc. ("AMEX"), and the Chicago Board Options Exchange ("CBOE") have separately submitted to the Securities and Exchange Commission ("SEC"), under the Securities Exchange Act of 1934, proposed rule changes which would permit each to trade instruments designated as index participations ("IPs").^{1/} By Order dated April 11, 1989 ("SEC Order"), the SEC has approved each of these rule changes.

An index participation is essentially a contract to purchase or sell the value of an index measuring the prices of various stocks.^{2/} An IP does not convey title to any security or other asset. Rather than ownership of the index's component stocks,

^{1/} The PHLX instrument is known as a Cash Index Participation ("CIP"); the AMEX instrument, an Equity Index Participation ("EIP"); and the CBOE instrument, a Value Index Participation ("VIP").

^{2/} A stock index is a statistical composite measuring in the aggregate the change in the value of a group of securities which may reflect market prices and the number of shares outstanding for the issuers in the index. For example, the Standard & Poor's 500 Index is a broad-based measurement of changes in stock-market conditions based on the average performance of 500 widely held common stocks; this index is commonly known as the Standard & Poor's 500 (or S&P 500). The selection of stocks, their relative weightings to reflect differences in the number of outstanding shares, and the publication of the index itself are services of

(Footnote Continued)

an IP conveys an interest in the value of the index.

The price of the IP is established at the initiation of the contract. IPs have no fixed expiration date. The unit of trading will be 100 IPs unless otherwise designated by the exchange.^{3/} IPs contracts are to be cleared through the Options Clearing Corporation ("OCC").

IP traders will be able to purchase either long or short positions. Holders of both long and short positions will participate in changes in the value of the underlying index. The purchaser of the long position will earn the benefit of any increase in the index's value and suffer a loss on any decline. Conversely, the short will enjoy the benefit of any decline in value and suffer a loss on any increase. To realize profits or limit losses on their positions, traders may enter into an offsetting sale or purchase of an IP in a closing transaction and receive or make payment of the difference between the cost of the opening and closing transactions.^{4/}

(Footnote Continued)

Standard & Poor's Corporation, a Financial advisory, securities rating, and publishing firm. The index tracks 400 industrial company stocks (also called the Standard & Poor's 400), 20 transportation stocks, 40 financial company stocks, and 40 public utilities.

^{3/}Each IP contract will represent the index value times a multiplier designated by the exchange.

^{4/} For example, a long who deposited the full contract value of \$1000 at initiation would receive \$500 in an offset if the index declined 50% in value. In the same circumstance, the opposite
(Footnote Continued)

Alternatively, longs may elect to realize profits or limit losses on their positions through exercising a "cash-out" privilege which allows the long to liquidate his position and receive the index's current value. In the event of a cash-out, a settlement is effected by cash payment to the long from a short. Depending upon the specific IP, traders can exercise this cash-out privilege on a daily, quarterly, or semi-annual basis.

Since an IP does not constitute the purchase or sale of the stocks which underlie the index on which an IP is based, it confers neither voting rights nor rights to receive actual dividends connected with the ownership of stock. However, an IP does entitle the long to receive from a short additional payments computed by reference to the dividends paid on the portfolio's component stocks. To accomplish this, the OCC credits the accounts of the longs, and debits the accounts of those who are short the day prior to cash-out time, a proportionate amount of any regular cash dividends declared on the component stocks.

IPs would be a book entry type of instrument. No certificates will be issued to holders. Rather, outstanding IP positions will be evidenced by the records of the OCC, broker-dealers and customer confirmations and account statements. In addition, IPs will have initial and maintenance margin requirements. Long IP positions will be required to post 100% of

(Footnote Continued)
short who had deposited \$500 at initiation would, in an offset, receive \$1000, the initial margin, plus the \$500 profit.

the initial price of the instrument, but may borrow up to 50% from their broker.^{5/}

Aside from these general characteristics, each IP designed by the three exchanges would have some unique features. The PHLX instrument (CIP) would permit holders to cash-out on a daily as well as a quarterly basis. The AMEX contract (EIP) would enable purchasers to exercise a cash-out privilege on a quarterly basis. In addition, a holder of a substantial long EIP position not cashing out may, subject to certain conditions, obtain delivery of the proportionate shares of each stock of the underlying indexes at quarterly cash-out time.^{6/} The CBOE contract (VIP) would allow sellers as well as purchasers to exercise a cash-out privilege on a semi-annual basis.

Furthermore, each IP will be distinguishable to the extent that each is traded on a different index selected by each exchange. PHLX CIPs will be based on the PHLX Blue Chip Index and the S&P 500 Index. AMEX EIPs will be based on the Major Market Index developed by AMEX and the S&P 500 Index. CBOE VIPS will be based on capitalization-weighted CBOE 50 and CBOE 250

^{5/} The SEC Order refers to this payment as "the full purchase price" but the payment does not go directly to the seller of the IP; rather, it is held in an account at the OCC. Thus, it is more accurate to refer to this payment as margin.

^{6/} AMEX will designate the number of EIPs necessary to qualify for the optional physical delivery. A delivery fee will be charged. Notices requesting delivery will be allocated on a random basis to short positions that have notified the OCC of a desire to make delivery.

portfolios developed by the exchange and the S&P 500 Index. The values of the underlying indexes will be published by each exchange.

For the reasons which follow, the CFTC considers IPs to be futures contracts and not (a) securities, (b) forward contracts, (c) hybrids, or (d) some other miscellaneous instrument not subject to CFTC jurisdiction.

B. IPS ARE FUTURES CONTRACTS.

1. Elements Of A Futures Contract

Section 2(a)(1)(A) of the Commodity Exchange Act ("CEA") grants to the CFTC exclusive jurisdiction over "accounts, agreements (including any transaction which is of the character of . . . an 'option' . . .), and transactions involving contracts of sale of a commodity for future delivery traded or executed on a contract market" 7 U.S.C. § 2.^{7/} Section 2(a)(1)(B) of the CEA repeats this grant of exclusive jurisdiction with respect to futures contracts on stock indexes. 7 U.S.C. § 2a. However, the term "contract of sale of a commodity for future delivery," commonly known as a commodity futures contract, is not specifically defined in the CEA.^{8/} As a result, to determine

^{7/} Futures contracts may be traded lawfully only on contract markets designated by the CFTC. 7 U.S.C. § 6(a).

^{8/} The term "commodity" is defined in the CEA. In addition to the traditional agricultural products, it embraces "all other
(Footnote Continued)

whether a particular instrument constitutes a futures contract, one must also look to the legislative history of the CEA, CFTC and court decisions, as well as agency interpretations.^{9/}

(Footnote Continued)

goods and articles, except onions . . . and all services, rights, and interests in which contracts for future delivery are presently or in the future dealt in" Section 2(a)(1)(A), 7 U.S.C. § 2. As further discussed below, the term "commodity" also includes "a group or index of securities (or any interest therein or based upon the value thereof)." Section 2(a)(1)(B), 7 U.S.C. § 2a.

^{9/} See, e.g., CFTC v. CoPetro Marketing Group, Inc., 680 F.2d 573 (9th Cir. 1982); CFTC v. Wellington Precious Metals, Inc., No. 85-3565 (S.D. Fl. 1988); NRT Metals, Inc. v. Manhattan Metals (Non-Ferrous) Ltd., 576 F. Supp. 1046 (S.D.N.Y. 1983); CFTC v. National Coal Exchange, Inc., [1980-1982 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 21,424 at 26,046 (W.D. Tenn. 1982); CFTC v. Commercial Petrolera Internacional S.A., [1980-1982 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 21,222 at 25,088 (S.D.N.Y. 1981); In the Matter of First National Monetary Corp., [1984-1986 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 22,698 at 30,970 (CFTC 1985); In re Stovall, [1977-1980 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 20,941 at 23,775 ((CFTC 1979); OGC Interpretative Letter No. 86-7 (Status of Live Hog Delivery Contracts), [Current Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 23,455 at 33,210 (Nov. 26, 1986); OGC Interpretative Letter No. 86-5 (Export Trading Company's Proposed Financial Credit Arrangements), [Current Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 23,227 at 32,616 (June 17, 1986) ("no-action" letter); OGC Interpretative Statement (Characteristics Distinguishing Cash and Forward Contracts and "Trade" Options), 50 Fed. Reg. 39656 (Sept. 30, 1985); OGC Interpretative Letter No. 85-2 (Bank Activities Involving the Sale of Precious Metals), [1984-1986 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 22,673 at 30,854 (Aug. 6, 1985); OGC Statutory and Regulatory Interpretation (Regulation of Leverage Transactions and Other Off-Exchange Future Delivery Type Instruments), 50 Fed. Reg. 11656 (Mar. 25, 1985); see also, Advance Notice of Proposed Rulemaking, "Regulation of Hybrid and Related Instruments," 52 Fed. Reg. 47022, 47023 (Dec. 11, 1987).

There is "no bright-line definition or list of characterizing elements" which determines what constitutes a futures contract. CFTC v. Co Petro Marketing Group, Inc., 680 F.2d 573, 581 (9th Cir. 1982).^{10/} The CFTC and the courts have nonetheless recognized certain elements common to such contracts.^{11/} In general, commodity futures contracts encompass contracts for the purchase or sale of a specified amount of a commodity, with payment and delivery in the future at a price established when the contract is entered into. In addition, both parties to the contract are obligated to fulfill the terms of the contract at a specified price. While satisfaction of a futures contract may occur either by delivery or by entering into an offsetting transaction, in practice most contracts are settled by offset. Futures contracts are undertaken principally to assume (speculate) or to shift (hedge) the risk of price change without transferring title to (or by making or taking delivery of) the underlying commodity.^{12/}

^{10/} "The transaction must be viewed as a whole with a critical eye toward its underlying purpose." Id.

^{11/} As the Commission explained in In re Stovall, this is not to say that "all commodity futures contracts must have all of these elements" [1977-1980 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 20,941 at 23,779 (CFTC Dec. 6, 1979). Were it otherwise, the statutory scheme of the CEA could be readily evaded.

^{12/} See citations in n. 9, supra.

In addition to these core elements, there are other identifiable characteristics which, while not essential, serve to facilitate the trading of futures contracts on exchanges. These include standardized commodity units, margin requirements related to price movements, clearing organizations which guarantee counterparty performance, open competitive trading in centralized markets, and public price dissemination. 1985 Interpretation, Office of the General Counsel, Commodity Futures Trading Commission, 50 Fed. Reg. at 11657, n. 2; Advance Notice, 52 Fed. Reg. at 47023.

2. IPs Contain the Essential Elements of Commodity Future Contracts.

Simply stated, it is the Commission's view that trading in IPs would constitute the trading of a futures contract based on the value of a stock index because these contracts contain the essential elements just described. IPs are contracts that call for future delivery.^{13/} Specifically, they are contracts for the purchase or sale of a commodity (here, a stock index) for delivery in the future (here, sometime after the contract initiation, i.e., at the "cash-out" time) at the price established when the contract is entered into.

^{13/} See comment letters to Jonathan G. Katz, Secretary, SEC, from Jean A. Webb, Secretary, CFTC, dated April 29, 1988, June 1, 1988, July 8, 1988 and December 13, 1988 (attached).

The SEC Order concludes that an IP is nothing more than an agreement to buy or sell the current value of an index, and that an IP lacks "futuraity." Order at 33-36. As explained below, the Commission disagrees. In contrast to cash or spot contracts, IPs contain provisions to transfer the cash value of the index in the future, namely, at the "cash-out" time (and, in the case of the AMEX EIP, delivery of the underlying stocks on a quarterly basis).^{14/} An IP is actually an agreement for the long and the short to settle the contract for the value of the index at a future date. That this future date is not determined at the time the IP is entered into does not make it any less a future date.^{15/} Indeed, perpetual duration, which the SEC considers a characteristic of a security, is in fact a concept of futurity. Thus, like other stock index futures contracts regulated by the CFTC, IPs are obligations to pay or receive the value of an index at a future date.

^{14/} Indeed, it is noteworthy that there is disagreement among the exchanges as to the relationship between the price of IPs and spot prices. Thus, the PHLX has stated, "it [a .5% discount on longs] should also aid in assuring that CIPs do not trade at prices too far below the value of the underlying index." 53 Fed. Reg. 40814, 40815 (Oct. 18, 1988) (emphasis added). In contrast, the CBOE, in explaining why it allowed both sellers and buyers to choose cash-out times, criticized CIPs for possibly "trading at an even higher premium than when the market professional thought the initial position was beneficial." 53 Fed. Reg. 22754, 22756 (June 17, 1988) (emphasis added).

^{15/} In fact, there is currently an "undated futures market contract" traded on the Hong Hong Exchange. See Adam K. Gehr, Jr. "Undated Futures Markets," Journal of Futures Markets, Vol. 8, No. 1, p. 89 (1988).

The fact that the obligation is a present one also does not support the SEC's conclusion that IPs lack futurity. By definition, all contracts or agreements (futures or otherwise) create present obligations.^{16/} The futurity in a futures contract is the delivery or offset, not the obligation.^{17/}

In addition to futurity, IPs possess a second essential element of a futures contract, namely, both parties to an IP contract are obligated to fulfill the contract at the specified price even though the contracts may be satisfied either by delivery or offset. The Commission thus disagrees with the SEC's conclusion to the contrary (SEC Order at 36). The short is obligated to deliver the value of the index at a future time. Although in two of the contracts (CIPs and EIPs) the long selects the "cash-out" time (among certain specified times and conditions), it is significant that once it does so, it is clearly obligated to liquidate its position at that time.

IPs also manifest a third element: use for hedging or speculation rather than for taking delivery of the stocks underlying the index and thereby making a capital investment in a company. IPs will derive their worth not from ownership of

^{16/} Black's Law Dictionary at p. 291 (Fifth Edition, 1979) defines "contract" as "an agreement . . . which creates an obligation to do or not to do a particular thing."

^{17/} It should also be noted that in a futures contract, the price or pricing formula is determined at the initiation of the contract. See citations in n. 9, supra. In this regard, IPs are no different from other futures contracts.

underlying assets, but from the value of the underlying index of stock prices in the marketplace. Therefore, like other stock index futures contracts, IPs would be used principally to assume or shift price risk without transferring title to the underlying commodity.^{18/}

Finally, IPs have other characteristics which are understood to facilitate the exchange trading of futures contracts, such as standardized terms and conditions, a clearinghouse, and public price dissemination. One exception is that IPs would not be margined at the same level as most other futures contracts.^{19/} However, that difference is not dispositive. Rather, it merely reflects the fact that IPs are designed to be traded on securities rather than futures exchanges.^{20/} In any event, this form of margin is not an essential element of a futures contract; it simply facilitates the trading of futures contracts on the exchanges. Stated

^{18/} As noted, title cannot be transferred in the CIP or VIP. And although the EIP provides for optional delivery, it is likely that delivery of the stocks will not be routine because the minimum delivery unit is substantial. The delivery feature, however, does raise other concerns. See n. 25, *infra*.

^{19/} During times of market stress, margins on futures contracts have been set as high as 100% of the contract value. These margins are applied equally to both longs and shorts.

^{20/} Minimum margin levels for securities are set by the Federal Reserve Board. Under the regulatory system established by the Commodity Exchange Act, exchanges have full authority to set margin levels on a day-to-day basis as they deem necessary to reflect price volatility in any particular futures contract.

another way, if IPs were traded on futures exchanges, the margining arrangement for futures contracts could readily be applied.

3. The CFTC Has Exclusive Jurisdiction Over Stock Index Futures Contracts.

In 1981, the CFTC and SEC reached an agreement, known as the CFTC-SEC Jurisdictional Accord, to resolve a jurisdictional conflict which caused regulatory uncertainty regarding the development and marketing of new financial instruments.^{21/} The Accord was designed to provide certainty to both the futures and securities industries as to what could be traded and where.

Another goal of the Accord, which was codified by the 1982 amendments to Section 2(a)(1) of the Commodity Exchange Act (CEA) and Section 3(a)(10) of the Securities Exchange Act of 1934 (SEA) and other securities laws, was to maintain the traditional regulatory expertise of both agencies.^{22/} The Accord further reaffirmed the CFTC's jurisdiction over all futures trading, all options on futures contracts for all commodities, and options on foreign currencies not traded on national securities exchanges.

^{21/} S. Rep. No. 384, 97th Cong., 2d Sess. 22 (1982).

^{22/} Futures Trading Act of 1982, Pub. L. 97-444, 96 Stat. 2294 (1982); see S. Rep. No. 384, 97th Cong., 2d Sess. 22 (1982); H.R. Rep. No. 565, 97th Cong., 2d Sess., Part 1, 40 (1982); Hearings on S. 2109 before the Subcommittee on Agricultural Research and General Legislation of the Senate Committee on Agriculture, Nutrition, and Forestry, 97th Cong., 2d Sess. 295 (1982) (statement of Chairman Philip McB. Johnson).

The SEC, in turn, continued to regulate securities and options on foreign currency traded on a national securities exchange.^{23/}

With regard to stock index instruments, the Accord and the implementing legislation specify that the CFTC would continue to exercise exclusive jurisdiction over futures contracts on stock indexes and options on such contracts, and that the SEC would have jurisdiction over options directly on stock indexes.^{24/} Because, as explained above, IPs are futures contracts based on the value of stock indexes, it is the Commission's view that under the Accord, the CFTC has jurisdiction over these contracts.^{25/}

^{23/} The Accord also made explicit that the CFTC's jurisdiction over commodity pool operators did not affect the applicability of the federal securities laws to securities issued by commodity pools, and reserved for further study the appropriate jurisdictional framework for futures contracts on individual corporate and municipal securities. See CEA Sections 2(a)(1)(B), 4c(f), 4m(2), 7 U.S.C. § 2a, 6c(f), 6m(2) (1982). See also, e.g., SEA Sections 2b(1), 15 U.S.C. § 77b(1); Sections 3(a)(10), 9(g), 15 U.S.C. §§ 78c(a)(10), 78i(g).

^{24/} CEA, Section 2(a)(1)(B), 7 U.S.C. § 2a. See, e.g., H.R. Rep. No. 565, 97th Cong., 2d Sess. Part 1, at 38-39 (1981).

^{25/} For the CFTC to approve trading in IPs, such instruments would have to be in compliance with the CEA. Among other things, the CEA requires that stock index contracts be cash-settled. To the extent that the AMEX instrument has an optional delivery provision, that provision would be unlawful under Section 2(a)(1)(B)(ii)(I).

C. IPS ARE NOT SECURITIES.

1. Under The Accord, IPs Are Not Securities.

As explained above and in the Commission's comment letters to the SEC, a stock index is not itself a "security" under Section 3(a)(10) of the SEA. Under the Accord legislation, for a derivative instrument involving a stock index to constitute a security, it must be an "option on any security . . . or group or index of securities (including any interest therein or based on the value thereof)".^{26/}

An IP is neither an option on a security nor an option on a stock index.^{27/} Unlike options, both parties are fully exposed to potential gains or losses based upon the change of the underlying stock index. In contrast, in a stock index option contract, the option's premium establishes a maximum loss for the purchaser resulting from changes in the underlying index. To quote the PHLX, an option contract "only gives the holder the right, for a temporary period, to participate in any capital appreciation of the underlying asset above a certain level (the strike price)".^{28/} Equally significant, the purchaser of the

^{26/} See Section 3(a)(10) of the SEA, 15 U.S.C. § 78c(a)(10) (1982); see also Section 2(a)(1)(B) of the CEA, 7 U.S.C. § 2a (1982) (emphasis added).

^{27/} The PHLX itself acknowledges that its CIP contract is not an option. See letter dated February 3, 1988 to the Board of Governors of the Federal Reserve System.

^{28/} Id. at 3.

long side of an IP contract does not pay an option premium, which is typically a small portion of the value of the underlying asset.

2. Even If The Accord Is Presumed Inapplicable, IPs Are Not Securities.

Without discussing the CFTC-SEC Jurisdictional Accord, the SEC concludes in its Order that it has jurisdiction over the proposed instruments on the basis that IPs constitute "securities" under Section 3(a)(10) of the SEA. SEC Order at 26-33. The SEC finds that IPs possess "key characteristics of stock." SEC Order at 28. Alternatively, the SEC concludes that IPs could also be considered "certificates of interest" or "participations in" stock (SEC Order at 30) or "instrument[s] commonly known as a security". SEC Order at 32. However, for the reasons set forth below, IPs cannot be considered securities on these bases.

a. IPs Are Not "Stock".

"Stock" is essentially defined as ownership of a corporation represented by shares that are a claim on the corporation's earnings and assets.^{29/} In deciding whether an instrument should be considered a stock, it must first be determined whether the

^{29/} Downes & Goodman, Dictionary of Finance and Investment Terms, p. 399 (1985).

instrument possesses the usual characteristics that spring from this ownership. In Landreth Timber Co. v. Landreth, 471 U.S. 681, 686, 105 S. Ct. 2297, 2302 (1985), the Supreme Court identified these characteristics to include: (1) the right to receive dividends; (2) negotiability; (3) the ability to be pledged or hypothecated; (4) the capacity to appreciate in value and (5) voting rights.

In its Order, the SEC concludes that IPs possess several of the Landreth characteristics: (1) purchasers would receive quarterly cash payments of a proportionate share of dividends on component stocks; (2) IPs would be negotiable in the same way as exchange-traded stock since IPs would be transferable in exchange transactions; (3) purchasers could pledge or hypothecate their interests; and (4) IPs would appreciate in value along with the underlying component stocks. SEC Order at 28. While it acknowledges that IPs would not convey voting rights, the Order nevertheless concludes this factor would not be determinative because other types of securities also do not possess voting rights. Moreover, the SEC concludes that IPs have two other stock-like features, namely, they do not expire and they have similar purchase requirements and margin treatments. SEC Order at 29-30. As explained below, the conclusions that IP purchasers will receive dividends and that IPs are negotiable are not substantiated.

Dividends are traditionally defined as shares in a corporation's earnings granted by the corporate issuer.^{30/} The SEC states that IP purchasers would receive a "dividend payment" in the form of quarterly cash payments of a proportionate share of dividends on component stocks. SEC Order at 28. However, the payments received by IP purchasers would not meet the traditional definition of dividends. Rather, index participation payments are merely computed by reference to the dividends paid on the portfolio's component stocks. That is, payments would come from another IP participant, not from a corporation whose stock is represented in the index.^{31/}

The SEC also finds that IPs are negotiable since they are freely transferable in exchange transactions. SEC Order at 28. In reality, stock is considered negotiable to the extent that it can be freely transferred to anyone once its certificate is endorsed. It is then treated as any negotiable instrument under Article 8 of the Uniform Commercial Code ("UCC"). For this reason, the bearer of a stock certificate need not enter the market to receive a cash payment for the stock's value. By contrast, an IP trader could only cash-out through an exchange transaction. Under these circumstances, it cannot be concluded

^{30/} Downes & Goodman, supra, at 102.

^{31/} As stated above, this payment is accomplished by the OCC crediting the long's account and debiting the accounts of persons who are short the day prior to cash-out time. See PHLX Letter to Federal Reserve at 2.

that an IP is negotiable in the traditional sense. Thus, an IP has, at best, only two of the requisite characteristics of a stock.^{32/}

More importantly, the SEC Order obscures the fact that an IP does not constitute ownership of a corporation, the traditional essence of stock^{33/}. In the final analysis, what an IP trader possesses is the same interest as that possessed by a trader of the Chicago Mercantile Exchange's S&P 500 stock index futures contract, namely, an interest in the value of an index of stock.

b. IPs Are Not "Certificates Of Interest" Or "Participations In" Stock.

According to the SEC Order, an IP could also be considered a "certificate of interest" or "participation in" stock. In this

^{32/} In fact, it can be argued that IPs have merely one Landreth characteristic, namely, the ability to appreciate in value. The element of being able to be "pledged or hypothecated" pertains to IPs only in the narrowest sense of the term. Whereas an investor in securities can pledge or hypothecate his interest in securities to any lender or creditor as collateral, IPs can be pledged by a trader only as collateral to the broker. SEC Order at 29.

^{33/} Indeed, the lack of voting rights pointedly illustrates the lack of ownership interest. Moreover, corporate shareholders (and, in some circumstances, even those who ordinarily have no voting rights) must approve various extraordinary corporate matters, such as amendments of the articles of incorporation, sale or lease of assets not in the regular course of business, merger, consolidation, and dissolution. Henn and Alexander, Laws of Corporations, §§195, 340 (3rd ed. 1983). In contrast, IP holders will never have voting rights under any circumstances.

regard, the SEC perceives that IPs replicate a purchase of a securities portfolio because they track the value and benefits of the underlying stocks. SEC Order at 30. In addition, the SEC points to the fact that IPs are expressly termed "participations." Although the Order acknowledges that there would be no transfer of a paper certificate, it finds this factor not determinative since the IP "transfer system [is] similar to the immobilized depository system used in connection with other modern day security transfers." SEC Order at 31.^{34/}

That the IP is labeled a "participation" does not transform it into a "certificate of interest" or a "participation in" stock. See United Housing Foundation Inc., v. Forman, 421 U.S. 837, 95 S. Ct. 2051 (1975) (the fact that an instrument is currently styled a stock does not make it a stock). Furthermore, the fact that IPs "replicate" a purchase of a stock portfolio is irrelevant; CFTC-regulated stock index futures contracts (such as the S&P 500) do the same. In any event, even assuming that this nomenclature has some relevance, it is noteworthy that the IP is labeled an "index participation," not a stock participation. In other words, even the exchange nomenclature recognizes that the

^{34/} However, "immobilized systems" such as that operated by the Depository Trust Company require that certificates representing the stocks be deposited and contemplate that certificates be made available if the owner seeks delivery. These depository systems also permit the pledge of stock to lenders other than a broker, with UCC protections.

interest purchased is not in any stock but in the value of the index of the stock.

c. IPs Are Not Investment Contracts.

In addition to its conclusion that IPs fit within a few of the more specific terms enumerated in Section 3(a)(10) of the SEA, the SEC Order states that an IP could be considered an "investment contract" or an "instrument commonly known as a security." SEC Order at 32. These phrases are generally applied to instruments that do not possess all the attributes of other securities but have the same "economic substance" as other securities. Neither phrase can properly be applied to IPs.

The basic test for determining whether an instrument is either an "investment contract" or "instrument commonly known as a security" is enunciated in SEC v. W. J. Howey Co., 328 U.S. 293, 66 S. Ct. 1100 (1946). That decision requires an inquiry into whether the instrument involves an "investment of money in a common enterprise with profits to come solely from the efforts of others." Id. at 301.^{35/}

^{35/} The courts have treated the term "instrument commonly known as a security" as a catch-all, analyzing it under the Howey "investment contract" test. See Landreth, 471 U.S. at 691, 105 S. Ct. at 2304 n. 5; Forman, 421 U.S. at 852, 95 S. Ct. at 2060; See also. Tcherepnin v. Knight, 389 U.S. 332, 343, 88 S. Ct. 548, 556-557 (1967); SEC v. C. M. Joinder Leasing Corp., 320 U.S. 344, 350, 64 S. Ct. 120, 123 (1943).

The IP lacks two of these critical elements. In the first place, there is no "common enterprise."^{36/} Although the purchase or sale of the IP involves two traders (a long and short), only one will be able to derive profits from the transaction. As such, there is no common business venture from which both parties can hope to generate profits.^{37/}

More importantly, potential profits derived from IPs would not come from the entrepreneurial or managerial efforts of others involved in the common enterprise.^{38/} Once the purchase of an IP has been made, the trader's profits would depend solely on the movement of the market prices of all the stocks represented in the underlying index. See SEC v. Belmont Reid & Co., Inc., 794 F.2d 1388 (9th Cir. 1986) (transaction involving the sale of gold

^{36/} "Common enterprise" has been defined as one in which the "fortunes of the investor are interwoven with and dependent upon the efforts and success of those seeking the investment or of third parties," SEC v. Glenn W. Turner Enterprises, Inc., 474 F.2d 476, 482, n. 7 (9th Cir.), cert. denied 414 U.S. 821 (1973), or where "the fortuity of the investments collectively is essentially dependent upon promoter expertise." SEC v. Koscot Interplanetary, Inc., 497 F.2d 473 (5th Cir. 1974).

^{37/} Accounts to purchase IPs will be similar to other commodity futures accounts. A number of courts have held that futures trading accounts are not securities on the grounds that they lack a "common enterprise." See, e.g., Milnarik v. M-S Commodities Inc., 457 F.2d 274 (7th Cir.), cert denied, 409 U.S. 887 (1972); Hirk v. Agri-Research Council, Inc., 561 F.2d 96 (7th Cir. 1977).

^{38/} The Ninth Circuit has interpreted this portin of the Howey test to mean "whether the efforts made by those other than the investor are the undeniably significant ones, those essential managerial efforts which affect the failure or success of the enterprise." G. W. Turner, 474 F.2d at 482.

coins on a prepayment basis held not to be an investment contract because the profits depended on fluctuations in the gold market, not on the efforts of others); Noa v. Key Futures, Inc., 638 F.2d 77 (9th Cir. 1980) (sale of silver bars was not an investment contract because the expected profits came from market fluctuations); P&C Investment Club v. Becker, [1980-1982 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 21,387 at 25,865 (E.D. Pa. 1981) (interest rate futures contracts held not to be investment contracts because no common enterprise, and expectation of profits arose totally out of changes in interest rates, not from the efforts of others); Sinva, Inc. v. Merrill, Lynch, Pierce, Fenner & Smith, Inc., 253 F. Supp. 359, 367 (S.D.N.Y. 1966) (contracts to purchase sugar for future delivery were not "investment contracts" because the expected profits came from market fluctuations). Accordingly, the IP cannot be said to come within the parameters of an "investment contract" or an "instrument commonly known as a security."

3. The CFTC Has Exclusive Jurisdiction Over IPs Even If They Fall Within the Definition of A Security.

Despite the apparent breadth of Section 3(a)(10) of the SEA, the courts have recognized that the SEC's jurisdiction is not unlimited. In holding that a certificate of deposit was not a "security" even though it came within the broad statutory definition, the Supreme Court has made clear that the SEC's jurisdiction could, in certain situations, be limited where there is an overlapping federal regulatory scheme. Marine Bank v.

Weaver, 455 U.S. 550, 102 S. Ct. 1220 (1982). One such limitation is the CFTC's exclusive jurisdiction over futures contracts.^{39/}

In amending the CEA in 1974, Congress sought to correct perceived deficiencies in the old regulatory scheme, in particular, inconsistent and duplicative applications of state law and federal securities laws to commodity futures transactions.^{40/} To this end, Section 2(a)(1) of the CEA vests the CFTC with exclusive jurisdiction over all futures contracts, even those which may involve securities. See Messer v. E.F. Hutton & Co., 847 F.2d 673 (11th Cir. 1988).^{41/}

^{39/} Later decisions have interpreted Marine Bank as requiring an examination of the "underlying economic realities" of an instrument in order to determine whether it is a security. American Bankers Ass'n v. SEC, 804 F.2d 739, 753, n. 23 (D.C. Cir. 1986). While in Landreth the Supreme Court indicated that there is no need to apply the Marine Bank "economic substance" test if the instrument is plainly one of the enumerated traditional securities, 471 U.S. at 690, here, as shown, IPs do not fall within the class of "traditional" instruments.

^{40/} See, e.g., H.R. Rep. No. 975, 93rd Cong., 2d Sess. 36-49 (1974); S. Rep. No. 1131, 93d Cong., 2d Sess. 18-19 (1974); H.R. Rep. No. 963, 93d Cong., 2d Sess. 10, 40-58 (1974).

^{41/} Section 2(a)(1)(A) of CEA provides, in pertinent part, that "nothing contained in this section shall supersede or limit the jurisdiction at any time conferred on the Securities and Exchange Commission" This clause, commonly known as the "savings clause," does not affect the CFTC's exclusive jurisdiction over futures contracts. Rather, the clause was "meant to protect pending SEC investigations and on-going court proceedings, to protect state court jurisdiction over the contracts claims which form the basis of a futures contract and federal court jurisdiction over antitrust claims, and to preserve private causes of action in federal courts under the commodities laws."

(Footnote Continued)

Given the legislative purpose underlying the 1974 amendments, the courts have uniformly recognized that Congress conferred upon the CFTC exclusive jurisdiction over all futures contracts, regardless of the underlying instruments on which they are based. Messer, supra (trading of futures based on U.S. Treasury Bonds is governed by CEA); Point Landing, Inc. v. Ommi Capital International, Ltd., 795 F.2d 415 (5th Cir. 1986) (CFTC has exclusive jurisdiction over investments in commodity futures contracts involving silver traded on foreign exchanges through discretionary accounts); Mallen, supra, 605 F. Supp. at 1105 (N.D. Ga. 1985) (stock index futures and the discretionary accounts in which they are traded are subject to the exclusive jurisdiction of the CFTC).^{42/} Moreover, the Seventh Circuit has stated that even assuming an instrument (GNMA options) were considered both a security and a commodity, the CFTC would have exclusive jurisdiction. Board of Trade of City of Chicago v. SEC, 677 F.2d 1137, 1148 (7th Cir.), vacated as moot, 459 U.S.

^{42/} Indeed, the most logical way to read the CEA and SEA together is to interpret the CFTC's exclusive jurisdiction as encompassing all futures contracts, even if they would otherwise fall within the definition of a security. See Kupke v. Shearson/American Express, Inc., [1984-1986 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 22,757 at 31,154 (M.D. Fla. Oct. 1985). Declining to follow the holding in Moody v. Bache & Co., 570 F.2d 523 (5th Cir. 1978), that discretionary commodity accounts were securities and therefore, subject to the securities laws, the court in Kupke held that "considering the legislative changes [to the regulatory scheme] the federal securities laws are . . . preempted in cases dealing with discretionary commodities accounts." Id. at 31,155.

1026 (1982).^{43/} Applying these principles here, even if IPs were presumed to fall within the definition of a security, the conclusion is inescapable that the CFTC would nevertheless have exclusive jurisdiction over these instruments because they are also futures contracts.^{44/}

D. IPS ARE NOT FORWARD CONTRACTS.

Section 2(a)(1)(A) of the CEA specifically excludes from Commission jurisdiction over futures contracts "any sale of any cash commodity for deferred shipment or delivery." This provision, known as the forward contract exclusion, originated in the Futures Trading Act of 1921. It was intended to permit off-exchange cash commodity transactions between persons involved in a commercial business involving that commodity where actual delivery of a physical commodity was contemplated but was delayed or deferred for reasons of commercial necessity or conven-

^{43/} This case was vacated as moot with the enactment of the 1982 amendments to the CEA and SEA, reflecting the CFTC-SEC Jurisdictional Accord.

^{44/} Note that IPs are not hybrids for the reasons set forth in Part E, infra.

ience.^{45/} In 1985, the Commission's Office of General Counsel issued an interpretative statement which comprehensively discussed the parameters of a forward contract:

First, the contract must be a binding agreement on both parties to the contract: one must agree to make delivery and the other to take delivery of the commodity. Second, because forward contracts are commercial merchandising transactions which result in delivery, the courts and the Commission have looked for evidence of the transactions' use in commerce. Thus, the courts and the Commission have examined whether the parties to the contracts are commercial entities that have the capacity to make or take delivery and whether delivery, in fact, routinely occurs under such contracts.

50 Fed. Reg. at 39657-39658 (Sept. 30, 1985) (footnotes omitted.)^{46/}

IPs do not come within this definition of forward contracts. There is no expectation of delivery of the commodity, i.e., the stock index.^{47/} Furthermore, IPs are not privately-negotiated contracts. Rather, like conventional exchange-traded futures contracts, they are instruments to be entered into by persons unaware of the identity of persons on the other side. Finally,

^{45/} For an extensive discussion of the legislative history of the forward contract exclusion, see In re Stovall, [1977-1980 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 20,941 at 23,775 (CFTC Dec. 6, 1979). See also, 44 Fed. Reg. 13494, 13498-13501 (Mar. 12, 1979).

^{46/} See also citations in n. 9 and 45, supra.

^{47/} In fact, by law, stock index futures contracts are cash-settled and may not provide for delivery of the component stocks. 7 U.S.C. § 2. Moreover, with regard to the optional delivery of the underlying stocks in the AMEX EIPs, it is our understanding that because of the conditions necessary to request delivery, delivery would not routinely occur.

IPs are not non-speculative transactions between commercial parties; instead, they are offered to the public and may be purchased for hedging or speculation by all types of traders. Thus, IPs would not be excluded from CFTC jurisdiction as forward contracts.

E. IPS ARE NOT HYBRID INSTRUMENTS.

In recent years, the Commission has witnessed the development of hybrid instruments that couple elements of futures or commodity option contracts with debt obligations or other interests that are not subject to regulation by the Commission. The development of these hybrid transactions initially gave rise to uncertainty concerning their treatment by the Commission under the CEA. In response, in late 1987, the Commission issued an Advance Notice of Proposed Rulemaking, 52 Fed. Reg. 47022 (Dec. 11, 1987), seeking comments on possible approaches to the regulation of these hybrid transactions. This was followed by the publication in January 1989 of proposed regulations and a statutory interpretation.

Specifically, the proposed regulations, published in January 1989, would exempt from Commission jurisdiction certain hybrid instruments with limited commodity option components. Proposed Rule, "Regulation of Hybrid Instruments," 54 Fed. Reg. 1128 (Jan. 11, 1989). The Commission's statutory interpretation, published at the same time, recognizes an exclusion from CFTC regulation for certain other hybrid instruments that are bona fide debt or

depository instruments that have some characteristics of commodity futures or options. 54 Fed. Reg. 1139 (Jan. 11, 1989).

IPs do not fall within the definition of exempt hybrid instruments. First, they are not debt or depository instruments.^{48/} Moreover, they do not have two components (both a debt or depository component and a commodity component). Rather, as explained above, IPs are futures contracts. Therefore, the proposed regulations on hybrid instruments are clearly inapplicable.

F. IPS ARE NOT OTHER MISCELLANEOUS INSTRUMENTS EXEMPT FROM CFTC JURISDICTION.

Other than the forward contract exclusion and the proposed hybrid instrument exemption discussed above, the only other transactions exempted from Commission jurisdiction over futures contracts are those encompassed by the "Treasury Amendment." This amendment, included in Section 2(a)(1) of the CEA in 1974 at the request of the Department of the Treasury, exempts from CFTC jurisdiction "transactions in foreign currency" and other specified financial instruments. The Amendment was intended to

^{48/} The Commission has requested comments as to the "appropriateness and the manner of delimiting equity and other interests as hybrid instruments . . ." 54 Fed. Reg. at 1134, n. 26.

apply to such transactions between banks and other sophisticated and informed institutions.^{49/}

The Treasury Amendment is, on its face, inapplicable to IP contracts. As explained, IPs are neither transactions in foreign currency nor any of the other interbank instruments specified in the Amendment. Nor are IPs to be entered into exclusively by and between banks and other sophisticated and informed institutions.

^{49/} See CFTC v. American Board of Trade, Inc., et. al., 803 F.2d 242 (2nd Cir. 1986); Statutory Interpretation, "Trading in Foreign Currencies for Future Delivery," 50 Fed. Reg. 42983 (Oct. 23, 1985).

Question No 2: What steps has the CFTC taken to consult with the SEC over the past year while these products were under SEC review to resolve the jurisdictional concerns raised in the CFTC comment letters, including any discussion of this issue by the Working Group on Financial Markets? What further steps will you explore in attempting to resolve these issues?

Over the past year, the CFTC staff has met several times and had numerous telephone conversations with SEC Commissioners and various staff members. Included in those meetings and discussions were CFTC staff from the Division of Economic Analysis, the Divisions of Trading and Markets, the Office of General Counsel and Office of the Chairman. SEC staff were represented by their Division of Market Regulation and Economic Analysis. Chairman Ruder and Chairman Gramm also discussed the jurisdictional concerns.

The CFTC does not want to impede innovation and the development of financial products. The stock exchanges indicated that one aspect of IPs which they felt was important was the distribution and marketing advantage of the securities retail brokerage network. One offer of compromise made by the CFTC was to consider "cross-registration" of securities brokers under CFTC rules if the IPs were traded on futures exchanges.

Although the meetings were informative for all concerned, the SEC and CFTC were unable to resolve the jurisdictional issue. No further discussions have been held since the SEC issued its Order.

The jurisdictional question has not been discussed by the Working Group on Financial Markets. The mission of the Working

Group is to develop information and understanding of intermarket factors which affect market volatility and to cultivate coordinated regulatory responses in times of market stress. In studies analyzing the market break, there was discussion of "stock baskets" as a solution to volatility which may be caused by institutional program trading.^{1/} The IP product is not such a "stock basket". Rather, it is a retail product for the individual investor.

We would continue our dialogue with the SEC but understand their reluctance given the nascent litigation in the Seventh Circuit. We will provide them with a copy of this letter for their consideration.

^{1/} N.Katzenbach, An Overview of Program Trading and Its Impact on Current Market Practices (Dec. 21, 1987).

Question No. 3: Had these instruments been submitted to the CFTC as futures contracts, how would your regulatory treatment of them have differed from that of the SEC? Are there relevant issues or public policy concerns normally addressed in the CFTC's designation process which have not been considered in the SEC's approval process in this case? Are there futures regulatory protections applicable to CFTC-approved instruments which you believe should apply to index participations but would not under the SEC's regulatory system?

As explained, commodity futures can serve a hedging or price basing function. This is in contrast to other instruments, such as securities, which are for capital formation or other types of investment. Moreover, because futures contracts expose both longs and shorts to symmetrical gains and losses, the mechanics of trading and exchanges differ from those of securities trading. These fundamental differences in the two instruments have, over the last half-century, resulted in the development of separate statutory and regulatory schemes tailored to the particular functions of the instruments.

The CEA recognizes that futures transactions are "affected with a national public interest," are carried on in large volume by the public, and "are susceptible to excessive speculation and can be manipulated, controlled, cornered or squeezed to the detriment of the producer or the consumer and the persons handling commodities" and their byproducts. 7 U.S.C § 5. In this regard, the CEA focuses on protection of the competitive nature and integrity of the centralized markets, as well as on the protection of individual customers. Securities regulation, in contrast, is primarily focused on full disclosure about particular companies to the investor.

A. DESIGNATION PROCESS

To be designated as a contract market under the CEA, exchanges are required, among other things, to provide for the recordation of transactions (7 U.S.C. § 7(b)) and to keep such records available for inspection (7 U.S.C. § 7a(2)); to prevent the dissemination of false or misleading reports or information (7 U.S.C. § 7(c)) and the manipulation of prices (7 U.S.C. § 7(d)); to enforce exchange rules (7 U.S.C. § 7a(8)); and to submit for Commission review and approval all exchange rules (7 U.S.C. § 7a(1)), and (7 U.S.C. § 7a(12)). In addition, an exchange must demonstrate that designation of a proposed contract is in the public interest (7 U.S.C. § 7(g)). This "public interest" test includes an economic purpose test, which requires a board of trade to show that the contract is or can "reasonably be expected to be quoted or disseminated for price basing or utilized as a means of hedging against possible loss through fluctuations in price."^{1/} To our knowledge the federal securities laws have no comparable public interest requirement before a new instrument is authorized to trade.

The Commission has adopted guidelines to provide further guidance to the exchanges on compliance with the CEA's

^{1/} Interpretive Statement, 47 Fed. Reg. 49832 (Nov. 3, 1982), reprinted in [1982-1984 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 21,606 at 26,320, quoting S. Rep. 1194, 93d Cong., 2d Sess. 36 (1974); See also Wong v. New York Mercantile Exchange, 735 F.2d 653, 662 n. 18 (2d Cir. 1984).

designation and self-regulatory requirements. See, Guideline No. 1, [Current Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 6135.50, p. 6066 (CFTC May 13, 1975); Guideline No. 2, [Current Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 6430, p. 6213 (CFTC May 13, 1975). New applications for contract market designation are scrutinized by the CFTC staff to determine whether the proposed contract meets these requirements. Notice of such applications is published in the Federal Register to afford the public an opportunity to comment on pending applications.

The staff reviews the provisions of proposed contracts to determine whether they are consistent with cash market practices so that these contracts are less susceptible to congestion or manipulation. In addition, proposed contracts are evaluated to ascertain whether they meet the economic purpose test--that is, whether a contract can reasonably be expected to be used on more than an occasional basis for hedging or price-basing. The staff also assesses the adequacy of the self-regulatory program of the applicant exchange. See, Guideline No. 2, supra.

The Commission's review of applications for contract market designation is thorough. In addition to publication in the Federal Register for public comment, the Commission solicits the advice of other government regulators who may have a particular interest in a contract or expertise regarding the underlying cash

market.^{2/} The staff also solicits the views of knowledgeable trade sources and others. Where the Commission finds deficiencies with either the proposed contracts or the applications, the exchanges are afforded an opportunity to make appropriate amendments. Thus, applications may be significantly altered as a result of the Commission's review process.

Illustratively, if an IP were submitted for designation to the Commission, the staff would analyze its terms and conditions to assure that it was not conducive to price manipulation. In addition, under Guideline No. I, an IP would be analyzed as to pricing and how it can be used for hedging.

B. REGULATORY PROTECTIONS

There are many similar protections afforded by the commodities and securities laws. These include competitive market mechanisms, exchange self-regulatory systems, risk disclosure, registration of industry professionals and various specific customer protections. In addition, both securities brokers and futures commission merchants ("FCMs") are subject to similar net capital requirements. As a result, despite

^{2/} The CEA provides for consultation with other government agencies in the CFTC's designation process where a proposed futures contract involves specified underlying commodities. See Sections 2(a)(1)(B) (SEC role regarding stock index products) and 2(a)(8) of the CEA (consultation required with the Departments of Agriculture and Treasury and the Board of Governors of the Federal Reserve System). 7 U.S.C. § 2; 7 U.S.C. § 4a(g).

differences in the two regulatory schemes, both accomplish the same fundamental goals.

For example, securities customer funds are protected by an insurance fund against financial losses resulting from the broker's theft or misuse of funds. The fund is administered by the Securities Investor Protection Corporation ("SIPC"). Although futures customer margins are not insured, futures customer funds are nevertheless protected, but this protection is accomplished through the strict segregation of customer funds from the funds and property of the FCM. Specifically, Section 4d(2) requires that FCMs "treat and deal" with all funds and property received by them "to margin, guarantee, or secure" trades or contracts or "accruing . . . as the result of such trades or contracts" as the property of the depositing customer. Such customer funds and property must "be separately accounted for" and may "not be commingled" with the FCM's own funds or "be used to margin or guarantee the trades or contracts, or to secure or extend the credit, of any customer or person other than the one for whom the same are held"^{3/} 7 U.S.C. § 6d(2).

^{3/} The demonstrated strength of customer fund protections for futures customers is reflected in the historically low incidence of insolvency loss, a total of approximately \$10 million over a 50-year period, for futures customers. In contrast, an average of \$10 million is paid out each year by SIPC to reimburse such losses by customers of securities brokers. Follow-up Report on Financial Oversight of Stock Index Futures Markets During October 1987, CFTC Division of Trading and Markets p.78 and n. 83 (January 6, 1988).

The two regulatory schemes differ in several respects because of the CEA's direct focus on market protection. CFTC rules require contract markets to maintain a single record which allows the accurate trade reconstruction for each futures or option trade, including the time of execution. 17 C.F.R. § 1.35(e). The benefits of these trade reconstruction requirements were demonstrated during the October 1987 market break and are favorably cited in the Report of the Presidential Task Force on Market Mechanisms at 67 (January 1988) ("Brady Report"). The Brady Report noted that the futures clearinghouse information system allowed the assessment of trading time by trading customers; the stock exchanges have no comparable system which details trades and trading times by customers.

To detect and, if necessary, take swift remedial action against actual or attempted market manipulations, squeezes, corners, position limit violations, or any other events which may result in market emergencies, the CFTC has implemented an extensive market surveillance program to monitor the activities of large traders on a daily basis. Critical to the success of this surveillance program is the Commission's ability to require filing of reports by large traders that accurately describe the number of futures positions they hold or control. Section 4i of the Act, 7 U.S.C. § 6i, empowers the Commission to acquire the necessary information about large traders and their positions. Pursuant to Section 4i and its general rulemaking authority under Section 8a(5) of the CEA, 7 U.S.C. § 12a(5), the Commission has

adopted regulations establishing reportable levels for different categories of large traders. See 17 C.F.R. Parts 15-19. The CFTC's large trader reporting requirement was favorably cited in the Brady Report (at 67), which noted that the large trader reporting system (as well as the previously discussed futures clearinghouse information system) allowed assessment of trading time by trading customers.^{4/}

Additionally, the CFTC has statutory authority to alter or supplement the rules of a contract market, Section 8a(7) of the Act, 7 U.S.C. § 12a(7), and to direct an exchange's action whenever it has reason to believe that an emergency exists. See, Section 8a(9) of the Act, 7 U.S.C. § 12a(9).^{5/} This enables the CFTC to order corrective measures to be taken in the face of market disruptions, if necessary. These market protections would not apply to these instruments if they were traded subject to the federal securities laws.

Separate and apart from the statutory market protections just described, the CEA also establishes grievance procedures for futures customers which provide additional remedial protections

^{4/} A bill currently before Congress, The Market Reform Act, H.R. 1609 and S. 648, provides that the SEC be granted similar authority over "large transactions or series of transactions in publicly-traded securities or options."

^{5/} The Market Reform Act, n. 4, supra, would also give the SEC authority to alter or supplement an exchange's rules in the event of an emergency.

that are unavailable to securities customers.^{6/} In particular, CFTC reparation proceedings may be instituted by futures customers against Commission registrants as an alternative to federal court litigation or arbitration. Section 14 of the CEA, 7 U.S.C. § 18. Such cases are heard by administrative law judges who hear only commodities cases. CFTC rules further provide that futures customers cannot waive their right to seek reparations. 17 C.F.R. § 180.3(b)(3). Nor may an FCM refuse to open a trading account based upon the customer's failure to enter into a pre-dispute arbitration agreement. 17 C.F.R. § 180.3(b)(1).

^{6/} However, the National Association of Securities Dealers does have a grievance procedure.