UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

THE CHAIRMAN

BY FACSIMILE

The Honorable David Ruder
Baker & McKenzie
130 East Randall Drive
Chicago, Illinois 60601

Dear David:

I am writing regarding S.207, a proposed amendment to the Futures Trading Practices Act of 1991, passed on March 6, 1991 by the Senate Agriculture Committee. S.207 addresses both the issue of margins on stock index futures and the scope of the exclusivity clause of the Commodity Exchange Act ("CEA").

The exclusivity provisions of S.207 would, in the view of the current Commission, be extremely bad public policy, considerably worse than the status quo. Section 303 of S.207 would give the Commodity Futures Trading Commission ("CFTC") jurisdiction over "[a]ny transaction in or involving a commodity" not exempted by the CFTC under other provisions of S.207. Since "commodity" is defined in section 2 of the CEA to include all goods and services except onions--an expansive definition confirmed by the narrow exceptions in S.207 for swaps and deposits--the CFTC would apparently acquire jurisdiction over stock index options and perhaps even over options on individual stocks. The transfer of jurisdiction over stock index options, and the possible transfer of jursidiction over individual stock options, would reverse the SEC-CFTC accord of 1982, and the historic authority of the SEC over options.

S.207 purports to exempt securities and some hybrids from its expansive reach by exemptions for instruments that derive less than 50% of their value from commodity option or future components. One problem with this test is that the valuation of an instrument's components depends upon, among other things, the options pricing model selected, the volatility factor used in the model, and the existence of ready markets to be used in estimating the value of components. Another, more serious problem, is that only the CFTC will decide whether 50% of an instrument's value derives from its option or future components. Given its past interpretations, it seems unlikely that the CFTC would ever find that a hybrid product satisfied the 50% exception. S.207 would thus transfer from the SEC to the CFTC the right to define a "security."

The details of our concerns are set out in the enclosed position paper. As I noted at the outset, S.207 has already passed the Senate Agriculture Committee; we understand that it will shortly be considered by Senator Reigle and the other members of the Senate Banking Committee.

If you have any questions or suggestions, please do not hesitate to call me, at 202-272-2000, or Rick Ketchum, at 202-272-3000. As always, we appreciate the support and comments of our former leaders.

Sincerely yours,

Richard

Richard C. Breeden
Chairman

Enclosure

THE CASE AGAINST S. 207

S. 207 Is Bad Policy

1. It carries "exclusivity" to new lengths:

S. 207 contains a series of provisions designed to strengthen the application of the "exclusivity clause" of the Commodity Exchange Act to banking, securities and other financial instruments. The proposed new provisions to strengthen exclusivity would be extremely bad public policy. Unless modified, the proposed language would be considerably worse than continuation of the status quo.

- S. 207 codifies the most expansive definition of exclusivity, subject only to the ephemeral possibility of occasional exceptions or exemptions at the sole discretion of the CFTC. The language of the bill would constitute legislated domestic protectionism.

- As a result, most new "hybrid" securities products would be prohibited or driven offshore.

- In addition, the $3 trillion index options market would apparently be transferred to CFTC oversight.

- Most swaps business would be driven to foreign markets, and what remained in the U.S. would operate under crippling conditions.

- Even demand deposit accounts and other banking products would implicitly be regarded as subject to assertion of exclusivity -- though the CFTC would have less discretion to abolish deposit products than swaps or securities hybrids.

2. S. 207 will stifle competition:

Increased competition and innovation within the financial markets are critical to future economic growth and prosperity. Wherever possible, our laws should allow securities and futures instruments to be offered to investors free of arcane and unnecessary restrictions. Low cost capital can be achieved by minimizing regulatory hurdles, litigation and uncertainty as to the lawfulness of innovative forms of securities and futures instruments.

- Sadly, the so-called "exclusivity clause" of the CEA currently restricts significantly the offering of new products.

- Although S. 207 purports to further these goals, in fact -- as currently drafted -- the bill will stifle competition and crush innovation.

- As currently written, S. 207 codifies into law the position that all financial instruments that the CFTC determines to include any degree of "futurity" must be exclusively traded on futures exchanges unless a product (i) meets an unrealistic mathematical test of the degree to which an instrument's "value" is based on a commodity, or (ii) receives a written exemption from the Commodity Exchange Act from the CFTC.

3. <u>S. 207's 50% value test is misleading:</u>

While the bill provides the pretense of fairness through its "50% value" test, that test is misleading.

- Since only the CFTC would decide when an instrument's "value" is tied to a commodity, and since under the CFTC's existing analysis, new equity products with characteristics of both futures and securities always are viewed as 100% futures, in fact there will not ever be any equity-related hybrid that the CFTC would concede meets the requirements for the 50% exception.

- In effect, for the first time in history, the SEC would be denied the right to define what is a security, and this function will be solely conferred on the CFTC.

4. <u>There will be no exemptions from this "iron law" of exclusivity:</u>

Under S. 207, the CFTC would be entitled, but not required, to allow the trading or sale of "any agreement, contract or transaction ... either unconditionally or upon stated terms or conditions or for stated periods ... ." Exemptions "may" be granted where the CFTC decides "that such exemption would be consistent with the public interest."

- Although the legislation appears to give the CFTC wide exemptive power, essentially all financial products would remain illegal until proven otherwise. In addition, S. 207 would prohibit the CFTC from granting an exemption unless an applicant proves the existence of at least five factors "to the satisfaction of" the CFTC.

These factors are:

1) Transaction involves solely institutional participants

2) Transaction is for hedging or risk management purposes

3) No material adverse effect on ability of CFTC to perform its regulatory duties

4) No material adverse effect on futures exchange's performance of self-regulatory duties

5) CEA should not apply and exemption is consistent with the public interest

5. S. 207 shifts the burden of proof unfairly to the innovator:

The anticompetitive intent of S. 207 is demonstrated by its provision that requires a would-be competitor to demonstrate that there will not be any "material adverse effect ... on the ability of ... any contract market to discharge its ... self-regulatory duties ...." This appears specifically designed to allow futures exchanges to veto any exemption for a product that would compete with their own.

- No standards for the showing of harm to one of the futures exchanges are set forth in the language.

- Harm to the securities exchanges is never measured or considered, though they are the source of capital for much of American business.

S. 207 Should Be Improved -- There Is a True Alternative for Hybrids

1. The SEC proposal: a true alternative:

The language of S. 207 should be revised to permit clearly and unequivocally the development of innovative securities products. In order to encourage competition and innovation, if the SEC determines that more than 50% of the features or characteristics of a product are those of a security (even if that product has some elements of a futures instrument), it should be exempt by statute from the exclusivity clause, so that the product would be eligible for trading in the U.S. securities markets. Similarly, if the CFTC determines that 50% or more of the features or characteristics of a given product are those of a commodity futures contract, that product should be free to trade on a commodity exchange, even though the product has some elements of a security.

2. The alternative for hybrid commodity instruments:

As currently drafted, S. 207's hybrid commodity instrument exemption would chill the development and introduction of new hybrid securities products. As drafted, the "50% value standard" depends, among other things, upon (1) what options pricing model is selected, (2) what volatility factor is assumed, and (3) whether there is a ready market by which to compute the value of the options or futures component.

- The 50% value standard is not useful in analyzing innovative new products such as index participations that have characteristics of both securities and commodity options or futures. Under the analysis employed by the CFTC in the past, such products would always fail the 50% test, even though their predominant features are those of a security.

- A more relevant test for the statutory language would be whether 50% or more of the "characteristics" of an instrument, not its "value," are those of a commodity or those of a security. For an equity product, mathematical computations of "value" measure only one limited aspect for determining whether or not the instrument is predominantly a security. Accordingly, any "50% test" should be based on all "characteristics" of the instrument, not simply one of many characteristics.

- More broadly, any 50/50 test for allowing trading rights should provide that an instrument could be traded in the securities markets if "the instrument is determined by the Securities and Exchange Commission to have at least 50 % of its value or characteristics derived from elements of a security as defined under Section 3(a)(10) of the Securities Exchange Act of 1934 or Section 2(1) of the Securities Act of 1933."

3. The need for broader exemptions for Index Participations:

S. 207 exempts only Index Participations ("IPs") that were approved for trading prior to April 11, 1989, or pending such approval on or before December 31, 1990. This provision simply creates an exemption for six IPs. All future IPs proposed by any of the nation's securities exchanges or by the National Association of Securities

Dealers ("NASD") for NASDAQ trading would be forbidden, as would any successor products to the existing six IPs.

This anti-competitive restriction would lead to absurd results:

- Under the terms of this provision, only four securities exchanges would trade IPs, as only those exchanges had proposals to trade IPs included in the SEC's April 11, 1989 order or pending before the SEC by December 31, 1990. All other securities exchanges, including the Boston Stock Exchange, Pacific Stock Exchange, Midwest Stock Exchange, and Cincinnati Stock Exchange, as well as the NASD would be precluded from ever trading IPs.

- IPs would be allowed to cover the Standard & Poor's 500 Index, because it had been approved by the SEC, but would not be allowed on other stock indexes that the SEC would also approve, such as the Value Line index or indexes on foreign stock markets, such as on the Japanese or British markets.

- The bill would freeze in place all specifications of IPs, so that no useful refinements could be made in the future. For example, previous IPs provided for quarterly pass-through of dividends to the holders of IPs, but the bill would prevent an exchange from proposing a monthly pass-through of dividends.

- <u>There is absolutely no reason for such extreme limitations other than pure domestic protectionism.</u>

To ameliorate these concerns, the bill's version of Section 4c(f) of the CEA should provide that any IP approved by the SEC would be exempt from the CEA. This would be entirely consistent with the bill's intent of letting this useful and innovative product, which had volume of over 70 million IPs before it was abolished from the market by litigation, freely trade on a securities market. In addition, the section should specifically state that IPs are not considered futures.

<u>S. 207 Will Have Sweeping Adverse Impact</u>

<u>1. Impact on SEC Jurisdiction</u>

Rather than simply resolving the existing uncertainty over the legal status of new products, the proposal raises serious questions concerning the SEC's current authority under the federal securities laws. Indeed, the bill may be read to give the CFTC jurisdiction over stock index options, other stock index products, and, perhaps, options on individual securities.

- This would represent a massive transfer of the SEC's existing jurisdiction -- that in some cases has been exercised since 1934. Trading in index options alone last year aggregated $2.9 trillion, yet this activity on the Chicago Board Options Exchange, American Stock Exchange, New York Stock Exchange, Philadelphia Stock Exchange and the Pacific Stock Exchange would quite possibly become unlawful under the language of the bill.

- Aside from its regulatory implications, the bill would also require significant staffing and budgetary increases for the CFTC, an agency that does not offset its costs by fees as does the SEC.

Proposed Section 4c(g)(B)) would give the CFTC jurisdiction over any transaction "in or involving a commodity" not exempted under the bill. Since a "commodity" includes all goods and services in the world except onions, this would appear to cover any products "involving" stock indexes. Depending on the construction of the term "involving," it could also encompass options on the individual stocks comprising those indexes, or even the underlying securities themselves. Although the securities laws currently contain a provision explicitly giving the Commission jurisdiction over options, the fact that this proposal would be enacted subsequently could raise questions about the continued validity of the earlier provision. Such a result is clearly at odds with any responsible effort to clarify the scope of the CFTC's exclusive jurisdiction, and Section 4c(g)(B) should be deleted from the proposal in its entirety.

Under the Administration's bill, S. 2814, the philosophy was to permit competition and innovation wherever possible. The current language is designed to do exactly the opposite by restricting innovation and competition in virtually every imaginable case.

A better alternative:

- A much more competitive and less costly approach would be a true 50% test. Under this approach, if the SEC determines that a product eligible for listing on a securities exchange has characteristics that are 50% or more a security, it could be traded on a securities exchange. If the CFTC determines that a product eligible for listing on a futures exchange has characteristics that are 50% or more a future, it could be traded on a commodity exchange. If both agencies made such a finding, the products could trade on both types of exchanges. Long and expensive regulatory proceedings would not be necessary and competition would be maximized. This is entirely consistent with the President's express position on S. 2814, as well as his longstanding commitment to minimize, not maximize, regulatory restrictions on competition.

2. Impact on Swaps

S. 207 also sets out narrow exception and exemptive provisions for swap contracts that would have a devastating effect on that large and highly competitive market. While the exclusion may be intended to provide certainty, its limitations dramatically undermine its effectiveness. Specifically, the exclusion requires that any person entering into a swap agreement do so only to hedge or manage a business-related price risk.

- This requirement ignores the nature of the market and makes the exclusion unavailable to banks and other swap dealers.

- The exemptive provision is equally ineffective because it gives the CFTC complete discretion to grant no exemptions at all.

- The substantive requirements for any exemption are extremely restrictive, limiting swaps to institutional participations and where the creditworthiness of each party to the swap agreement would be a material term of the negotiation of the swap agreement.

- Finally, any efforts to improve the efficiency and liquidity of the swap market through developing a trading market would destroy the exemption. The inevitable result of these provisions will be to drive most swaps offshore and to hamper severely the operation of any market remaining in the U.S.

The specific statutory language changes that would address the problems of hybrid securities are included in Exhibit A, with additions underlined and deletions [bracketed].

EXHIBIT A

SEC. 303. HYBRID COMMODITY INSTRUMENTS.

Section 4c of the Act is amended by adding a new subsection (g) to read as follows:

"Sec. 4c(g) "(A) Notwithstanding any other provision of law, [n]othing in this Act shall be deemed to govern or in any way be applicable to any transaction which meets the following requirements--

"(1) to the extent that the instrument has elements of a commodity option, less than 50% of its characteristics are those of a commodity option, or the instrument derives less than 50 percent of its value at the date of issuance from the value of the commodity option, and

"(2) to the extent that an instrument has elements of a contract of sale of a commodity for future delivery, less than 50% of its characteristics are those of a contract of sale of a commodity for future delivery, or at the date of issuance it is expected that less than 50 percent of the change in the value of the instrument or its performance will be due to movement in the price of the commodity or commodities specified in the instrument or in the terms and conditions of the transaction pursuant to which the instrument was issued, or

"(3) the instrument is determined by the Securities and Exchange Commission to have at least 50% of its value derived from or 50% of its characteristics attributable to the elements of a security, as defined under Section 3(a)(10) of the Securities Exchange Act of 1934 or Section 2(1) of the Securities Act of 1933, or a group or index of securities; provided that this clause (3) shall not apply to transactions conducted on a designated contract market involving contracts of sale of a commodity for future delivery (or options thereon) or accounts and agreements related to such transactions.

["(B) Any transaction in or involving a commodity regulated under this Act not excluded by paragraph (A) above shall be subject to regulation by the Commission under sections 2(a)(1), 4, 4c or 19 of this Act."]

SEC. 304. INDEX PARTICIPATIONS

(a) Section 4c(f) of the Commodity Exchange Act (7 USC 6c(f)) is amended to read as follows:

"(f) (1) Nothing in this Act shall be deemed to govern or in any way be applicable to any transaction in an option on foreign currency traded on a national securities exchange.

(2) Nothing in this Act shall be deemed to govern or in any way be applicable to any contract traded on a national securities exchange <u>or quoted through an automated inter-dealer quotation system operated by a securities self-regulatory organization</u> whereby any party to the contract acquires any interest in a stock index participation unit approved for trading by the Securities and Exchange Commission<u>, and such stock index participation unit shall not be a contract of sale of a commodity for future delivery.</u>[by order dated April 11, 1989, or pending such approval on or prior to December 31, 1990.]

"(3) The Commission shall utilize its existing authority under this Act to facilitate the registration of any person who is a 'person associated with a broker or dealer' or 'associated person of a broker or dealer,' as those terms are defined in section 3(a)(18) of the Securities Exchange Act of 1934, for the purposes of marketing stock index futures (or options thereon) to the public."

IN ORDER TO TRADE HYBRID SECURITIES IN THE UNITED STATES WHAT DO YOU HAVE TO BE ABLE TO <u>PROVE</u> IN COURT?

1. Only Institutional Participants;
2. Only for Hedging or Risk Management;
3. Will Not Affect CFTC's Ability to Perform its Regulatory Duties;
4. Will Not Affect a Futures Exchange; and
5. Consistent with Public Interest.

or

1. Less than 50% of value is from Commodity Option;
2. Less than 50% of change in value is from Commodity Future; or
3. Less than 50% of performance is from Commodity Future.

WHO GETS TO DECIDE:

CFTC

WHO GETS TO CHALLENGE:

CBT	MCE
CME	MGE
COMEX	NYCE
KCBT	NYMEX
CSCE	

WHAT DO YOU HAVE TO PROVE IN COURT TO TRADE THE SAME PRODUCT IN LONDON?

NOTHING

UNDER S.207 WHO DECIDES WHAT CAN TRADE?

MARKET PARTICIPANTS:	SEC:	CFTC:	SECURITIES EXCHANGES:
Nothing	Nothing	All Equity Hybrids All Swaps All Hybrid Deposits All Debt Hybrids	Nothing

LIKELY RESULTS:

- Most hybrid products trade on Futures Exchanges or do not trade at all
- No equity-based hybrids, other than 6 pre-existing IPs, trade on Securities Exchanges
- Many hybrid products would be excluded from U.S. Markets and driven overseas
- Swaps Market devastated

S.207 WOULD HURT U.S. COMPETITIVENESS

STIFLES INNOVATION

- ★ Subjects hybrid securities having any element of a future to possible regulation under the CEA
- ★ Issuers would have to prove numerous detailed factors to the CFTC
- ★ Issuers could have an exemption revoked at any time
- ★ Issuers could be sued by Futures Exchanges seeking to prevent competition
- ★ 50% valuation test is a fraud. Under the CFTC's interpretation no new hybrid equity products will be permitted.

CHILLS COMPETITION

- ★ Would ban many hybrid securities products unnecessarily
- ★ Could subject stock index options and warrants to futures regulation
- ★ Kills swaps secondary market
- ★ Prevents innovation in II's products

IMPEDES CAPITAL RAISING

- ★ Reduces available means of raising capital for issuers
- ★ Forces U.S. issuers to try innovative capital raising methods overseas
- ★ Subjects issuers to cost of litigation for any new product

DOMESTIC PROTECTIONISM

- ★ Purpose is to prevent competition with Futures Exchanges
- ★ American businesses and consumers sacrificed to profits of Futures Exchanges
- ★ System designed to prevent new products from emerging

A TRUE COMPETITIVE ALTERNATIVE TO S.207 FOR HYBRIDS

CFTC
Determines a product eligible for listing as a future is 50% or more a commodity = trades on a Futures Exchange

SEC
Determines a product eligible for listing as a security is 50% or more a security = trades in the Securities Markets

- Most products would trade either on a Securities Market or on a Futures Exchange
- Some similar products might trade on both types of Markets
- No product would be excluded from U.S. Markets
- Minimal impact on the Swaps Market