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The Honorable Donald W. Riegle, Jr., Chairman
Committee on Banking, Housing and Urban Affairs
United States Senate
534 Dirksen Senate Office Building
Washington, D.C. 20510

Re: Title III to S. 207

Dear Senator Riegle:

The undersigned are former General Counsel of the Securities and Exchange Commission (the "SEC"). We write, not in any official capacity, nor on behalf of any client, but solely in the public interest, to express our strongly-held view that *Title III to S. 207 should not be enacted in its present form;* instead, we urge that *Title III should be modified* to avoid the internecine regulatory battles that prompted its drafting and that will ensue long after the legislative debate over S. 207 has ended if the bill were enacted in its present form.

Entitled "Intermarket Coordination," Title III attempts to define, among other things, the respective jurisdictions of the Commodity Futures Trading Commission (the "CFTC") and the SEC with respect to a new generation of financial instruments, not comprehended by either the legislation pursuant to which the CFTC was created nearly twenty years ago, or the organic statutes that launched the SEC nearly six decades ago. The financial instruments that would be affected by Title III are often referred to as "hybrid instruments," because they combine some or all of the characteristics of traditional securities (such as equity and debt instruments currently traded on organized securities markets) and some or all of the characteristics of futures-related contracts (such as those currently traded on designated contract markets).

There is no dispute about the need for legislation. Because current law does not comprehend these hybrid instruments, and the many forms of instruments that surely will evolve in our financial markets over the coming years, the important task of setting policy initiatives for our financial markets has been relegated to the judiciary, the branch of government most ill-

equipped to fashion a regulatory framework for the future. That is the function of the Congress, and one that the Congress should insist on performing itself. The courts are limited when confronted with the question whether a particular instrument should be regulated either as a security, or as a commodity futures contract, and must apply *existing* law to instruments existing law never envisioned. The result to date has been a patchwork quilt of hastily-devised compromises, constant litigation, conflicting legal views about the ability of both the CFTC and the SEC to regulate the financial markets, unseemly regulatory competition, and, most importantly, uncertainty for business men and women who cannot predict with any degree of certainty whether a particular instrument must be subjected to the regulatory scheme of the SEC or the regulatory scheme of the CFTC.

This problem has been prevalent since at least 1974, and might prompt one to inquire why a legislative solution is critical at this juncture. The answer, we believe, is relatively straightforward. In light of recent decisions, the courts apparently will apply a mechanistic test for determining where jurisdiction over a particular financial instruments lies — if there are *any* elements of a futures contract (a test so vague as to be dangerous, since it could, applied literally, reach equity securities), it is likely that the courts will enforce an "exclusivity" provision in the CFTC's enabling legislation to preclude SEC jurisdiction over the instrument. This test has been crafted not at the behest of the regulators, but at the behest of those who seek to prevent the development of new, and possibly competing, financial instruments.

The current state of the law, therefore, discourages innovative new financial products, given the high cost of litigation and the uncertainty of the outcome of such squabbles. Worse, this situation encourages those with ideas for new financial instruments to avoid United States jurisdiction altogether, since CFTC jurisdiction carries with it a requirement that any hybrid instrument be traded on a CFTC-designated contract market, whereas many of these instruments are not sufficiently standardized to warrant such trading, or to make such restrictions palatable. The result is simply that *no* regulation of these instruments will exist, and the United States will be the worse off. Congress' policy goals — the effective regulation of securities and commodity futures contracts — will be thwarted. Only an amendment to existing law can accomplish this goal.

As currently drafted, however, Title III would vest "exclusive jurisdiction" in the CFTC over any hybrid instrument if at least fifty percent of its overall value was related somehow to commodity futures. In addition, Title III would subject some, but not all, index participations ("IP") to the exclusive jurisdiction of the CFTC. In our view, these provisions represent an ill-advised continuation of the very same *as hoc* approach utilized in the past that has made the resolution of the regulatory fragmentation so intractable in the first instance.

While Title III recognizes that hybrid instruments, by their very nature, may implicate both the securities and commodity futures regulatory schemes, its provisions ignore the legitimate interests that both the SEC and the CFTC may have in such instruments by vesting exclusive jurisdiction in *either* one agency or the other. Rather than establish a framework in which the fundamental objectives of both regulatory schemes can coexist and interact, Title III would impose on issuers, financial markets and market participants an arbitrary fifty percent

value test. Under Title III, if forty-nine percent of an instrument's overall value is somehow related to a commodity, it may trade freely without CFTC oversight. If, however, an additional one percent of its overall value is related (in ways undefined at present) to a commodity, the instrument would be permitted to trade only on a designated contract market or not at all. We find it inexplicable how this one percent increase could so jeopardize the fundamental objectives of the CFTC's regulatory framework so as to justify such radically anomalous results.

Title III applies this same arbitrary treatment to index participations — whether an IP is permitted to trade on a securities exchange depends, in effect, solely on whether the securities exchange in question had the necessary clairvoyance to seek early SEC approval for the IP offered by that exchange. Under Title III, securities exchanges which lacked the requisite foresight would be forever precluded from trading IPs, and those permitted to do so would be forever precluded from modifying those instruments for the benefit of investors. If IPs do not affect adversely the fundamental objectives of the CEA — a proposition which Title III explicitly endorses by permitting IPs to trade on securities exchanges — then all IPs should be permitted to trade irrespective of the date they were, or are, approved.

Title III also fails to provide the predictability required by rational business executives. Under Title III's value test, the valuation is determined at the date of issuance. In a typical underwritten offering of securities, however, the offering generally is priced, and the underwriting agreement signed, prior to the date of issuance. Hence, an instrument excluded from CFTC jurisdiction when priced, may well turn out to be within the CFTC's jurisdiction when issued.

Moreover, the application of Title III's value test may result in disparate treatment of the same or nearly identical hybrid instruments. By way of illustration, an instrument or transaction which might not have been subject to exclusive CFTC jurisdiction on the day it was first issued may become subject to CFTC jurisdiction upon a subsequent issuance of the same instrument because of unanticipated volatility in the related commodity. Likewise, within the same day, a hybrid instrument may be within the jurisdiction of the CFTC, while another hybrid instrument, structured in the identical manner, may be excluded from CFTC jurisdiction merely because it is linked to a different commodity.

Historically, the regulation of financial instruments has struck a balance between the protection of investors and market participants on the one side, and the freedom to offer innovative and beneficial products on the other. Title III ignores, rather than strikes, that balance. Title III would continue to prohibit vehicles designed for *bona fide* corporate purposes simply because they contain elements of futurity; notwithstanding the fact that comparable investor protections are in place under another regulatory scheme, or the fact that the designated contract markets on which they would be required to trade simply cannot accommodate such issuer-specific instruments. Under such circumstances, it seems only logical to permit the capital formation and investment process to be conducted under the regulatory scheme designed precisely for that purpose.

Today, world class issuers may choose many markets in which to finance. Because of competition, intermediaries throughout the world are constantly developing new products. To the extent the products have a hybrid quality to permit investors and companies to hedge against interest risk, currency risk and commodity prices, a question arises as to the applicable regulatory regime in the United States. Unfortunately, there is often a question as to whether these products are subject not only to the federal securities laws but also to the CEA if sold in the United States. If the product is subject to the CEA, it is simply not sold in the United States or to U.S. persons because of the time it would take to obtain approval. The structure of the CEA envisages that all future products — pork bellies to Government securities — must first be approved in advance for trading and then may only trade on an exchange unless certain narrow exceptions apply. Hybrid products are developed to be offered and sold in international capital markets generally to take advantage of changing market opportunities. Because of rapidly changing market conditions, they should be regulated as securities, relying upon full disclosure to investors of the appropriate terms.

There is no doubt that the exclusivity provision of the CEA, the CFTC assertion of jurisdiction over hybrid securities, and the fact that any new product is required to go through an approval process before it could come to the market means that the Euromarket and other international markets will continue to develop products for issuers, many of which will not be offered or sold in the United States, and the U.S. market will be limited to those products which the CFTC exempts from the CEA. If we are right, the CFTC will decide what new instruments may be sold in the securities markets, and the CFTC may be under pressure for competitive reasons to limit the number of products which may be sold and traded other than on a commodities exchange. Thus, we will see in the United States only those instruments where the value of the option and future component is less than 50% as determined by the CFTC. The rest of the world — but not the United States — will see whatever instruments investors find attractive.

Finally, Title III fails to provide a long-term solution to our fragmented regulatory structure. It applies an instrument-by-instrument paradigm that addresses only the immediate problem, and that ultimately will fail to address the next generation of financial instruments.

In our view, any legislative remedy that is to serve the public interest and strengthen U.S. financial markets must encompass certain fundamental principles. First and foremost, we believe that the fundamental objectives of the CEA and the federal securities laws remain valid today. Accordingly, any legislative remedy must permit the CFTC and the SEC to exercise and apply the minimal objectives of their respective regulatory schemes, if and as appropriate, while avoiding unnecessary and duplicative regulation. Second, a legislative remedy must provide predictability as to what rules and regulations will apply. Uncertainty is the bane of business. It eliminates market activity, discourages innovation and increases costs. Third, a legislative remedy must encourage competition — competition that will spur the development of innovative and beneficial products for U.S. financial markets at a reduced cost. Fourth, any legislative remedy must take into account the globalization of the futures and securities markets and the fact that beneficial instruments not permitted to trade in the United States will be traded elsewhere. Finally, any legislative remedy must provide a long term, rather than a piecemeal, solution.

We believe that an appropriate and mutually agreeable solution can be crafted that will embrace these fundamental goals. There are at least several readily available solutions that will resolve the current regulatory fragmentation, without generating the significant dislocations for U.S. financial markets, their participants, and investors that would be caused by the Congress' adoption of Title III. Certain of these legislative alternatives are outlined in our accompanying submission, and we are available to discuss those, and other possible solutions, with the Members of the Congress.

In all events, no amendment to the CEA should be adopted unless it is clear that the solution selected is the one best suited to encompass those fundamental principles which we believe have stood, and will continue to stand, the test of time. Such an assessment requires the type of development and analysis, both economic and legal, that only is forthcoming in full public debate, where all views may be aired and carefully considered.

For all of these reasons, we urge the Congress to reject Title III to S. 207 as presently drafted, and to amend the CEA to remove the rigid barriers, unforeseen and unintended, that have arisen to impede the development of new and useful products that further legitimate business purposes and diminish the global competitiveness of the United States.

Sincerely,

Daniel L. Goelzer Edward F. Greene Harvey L. Pitt