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THE SEC-CFTC ACCORD: ACCOMMODATION IN THE PUBLIC INTEREST

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I'm here to share with you some observations regarding the SEC-CFTC accord. I sought a joint audience of those from the securities and commodities committees of the Chicago Bar Association not only for symbolic reasons. As these two great industries and the agencies that regulate them grow closer, so too should their lawyers.

Impetus for the SEC-CFTC Accord

To grasp the impetus for our accord, to evaluate it, and to ponder the future -- all of which I should like to attempt briefly today -- one needs to recall some events of the recent past.

* Before 1974, the Commodity Exchange Act (CEA) applied mainly to agricultural commodities and was administered by the Agriculture Department.

* In 1974, Congress amended the CEA, creating the CFTC as an independent agency to regulate futures trading in commodities and expanding the definition of "commodity" to include not only tangible goods and articles (except onions) but "all services, rights, and interests in which contracts for future delivery are presently or in the future dealt in. . . ." With this amendment, virtually anything (other than onions) could become a commodity, subject to CFTC regulation, simply by its futures being traded on an exchange.

This accordian-like grant of jurisdiction to the CFTC was to be exclusive, but, subject to that exclusivity, the jurisdiction previously granted to the SEC was to be undisturbed. A neat example of legislative dovetailing, this amendment was not!

* It did not take long for the predictable turf battles to begin. When the CFTC authorized the Chicago Board of Trade (CBOT) to list futures on GNMA's, in the fall of 1975, the SEC questioned whether the CFTC's jurisdiction was exclusive with respect to futures trading on financial instruments and requested that the CFTC not permit additional trading in financial futures.

The views expressed in this speech are my own and do not necessarily represent those of the Commission, my fellow Commissioners, or the staff.

* In response, the CFTC authorized the Chicago Mercantile Exchange (CME) to trade futures on Treasury bills and then published a memorandum of law concluding that the CFTC's jurisdiction over futures trading was exclusive, even where the underlying instruments were securities.

* In 1978, in connection with the CFTC's reauthorization hearings, the SEC recommended that jurisdiction over financial futures, including options on futures, be vested in it, with the CFTC retaining jurisdiction over the more traditional commodity futures. Congress was not moved by these notions of symmetry. Nor did it choose to clarify the jurisdictional ambiguities embedded in the 1974 legislation.

* Between 1978 and 1981, the SEC commented on a number of board of trade proposals to list stock index futures contracts, at first questioning the CFTC's authority to approve trading in such contracts, and then raising investor protection concerns based on disparities in regulation under the Securities Exchange Act and the CEA.

* In 1981 the tempo quickened. Early in the year, the SEC approved a proposal of the Chicago Board Options Exchange (CBOE) to trade options on GNMA's. The CBOT promptly sued, petitioning the Seventh Circuit to set aside the SEC's approval order. Other stock exchange proposals to list options on exempted debt securities, foreign currencies and stock groups and indices were submitted to the SEC.

* Concurrently, on the futures front, boards of trade were submitting to the CFTC still more proposals for futures contracts on stock groups and indices and, in the case of the New York Futures Exchange, proposed futures contracts on bonds issued by AT&T and its subsidiaries.

* In the midst of this new product rush, and the underlying turf battle, the Reagan Administration installed new chairmen at the SEC and CFTC. Intensive negotiations, effectively led and staffed, yielded an accord on jurisdictional issues which was publicly announced after approval by the two Commissions and briefings of the leadership of the Congressional oversight committees.

* The accord was immediately attacked for not being negotiated under the public gaze, allegedly in violation of the Sunshine Act.

* When, in conformity with the accord, the SEC approved proposals by the CBOE and the American Stock Exchange to list options on Treasury securities, the SEC was promptly sued by the CBOT and the CME.

* And when the CFTC, again in conformity with the accord, approved the proposal of the Kansas City Board of Trade to list a futures contract based on the Value Line stock index, Congressman Dingell introduced a bill to impose a moratorium on all stock index futures trading.

* In February of this year, to protect the accord against any imagined vulnerability to whatever decision the Seventh Circuit might hand down, and thereby to permit trading in GNMA options on the CBOE at the earliest possible date, the CFTC proposed a rule exempting from CFTC regulation options on exempted securities.

* On March 24, 1982, a deeply divided panel of the Seventh Circuit derailed even this rule-making initiative of the CFTC, in a decision of awesome breadth and imagination. According to the majority, not only does the CFTC have exclusive jurisdiction over GNMA options, but the SEC, even apart from the Commodity Exchange Act, lacks <u>any</u> authority to authorize trading in options on exempt securities.

* On March 31, 1982, Chairmen John Shad and Philip Johnson reiterated their commitment to the accord in testimony before the Securities Subcommittee of the Senate Committee on Banking, Housing and Urban Affairs.

* And, finally, on April 7, 1982, the SEC, supported by the Federal Reserve Board, the Securities Investor Protection Corporation, the Securities Industry Association, the CBOE, the American Stock Exchange and the North American Association of Securities Administrators, filed a request for rehearing <u>en banc</u> before the Seventh Circuit and vacation of the court's decision pending <u>en banc</u> review.

The point counterpoint of this drama might delight a student of Bach. Students of government, on the other hand, might see it differently.

In any event, daring to grasp at the more optimistic possibilities, I will assume that the rapid progress in Congress of the legislative package now <u>essential</u> to carry out the accord will continue to fruition. On that basis it may be useful to speak briefly about the terms of the accord, evaluate it, and then look ahead somewhat into the future.

<u>Terms of the Accord</u>

Since you are all, no doubt, familiar with the terms of the accord, I will just touch on the principal points. The SEC will regulate trading in options on all securities,

including exempt securities, and on certificates of deposit and groups or indices of securities or CD's. The CFTC will have no jurisdiction over options on individual securities or security groups or indices. The CFTC will retain its authority to approve futures trading on exempt securities, other than municipal securities, and on CD's, as well as options on such futures. And the CFTC will be permitted to authorize futures trading on broad-based groups or indices of securities, as well as options on such futures, subject to conditions designed to protect against manipulation. Each agency will be empowered to approve trading of options on foreign currencies -- the SEC for such trading on national securities exchanges and the CFTC with respect to boards of trade.

Two other aspects of the accord merit mention. Neither agency will be permitted to authorize trading in futures contracts on individual corporate or municipal securities or options on such futures. And the SEC will continue to regulate the capital-raising and corporate functions of commodity pools and their operators pursuant to the securities laws, including, if applicable, the Investment Company and Investment Advisers Acts.

Evaluation of the Accord

In evaluating the accord, it is helpful to remember that the parties were not writing on a clean slate. There were the relevant statutes, with all their ambiguities. And there were the markets, which were proceeding to develop apace without the accord.

The economic uncertainty of the past decade, punctuated by high rates of inflation and interest, caused money itself to be viewed as a commodity and led to the development of new financial futures instruments. While activity in the traditional agricultural and natural resource commodities increased in varying degrees, and in some areas even declined, the growth rate for financial futures was truly phenomenal. In 1977, under one million futures contracts were traded on financial instruments and foreign currencies. By 1981, the total was well over 25 million contracts. Last year, financial futures and foreign currency contracts accounted for almost 30% of the total trading volume on all boards of trade. The single most actively traded commodity contract was the CBOT's Treasury bond contract. These numbers are impressive. They demonstrate the importance of financial futures trading to the boards of trade.

The agencies recognized that the accord ought not disrupt existing markets. While a logician might have been tempted to concentrate in one agency jurisdiction over all forms of trading in securities and their derivatives, as Holmes put it: "Upon this point a page of history is worth a volume of logic." The SEC had pressed its case before Congress in 1978 and lost. Congress continued to favor the logic of concentrating in one agency regulation of futures trading in all forms of commodity, including securities.

The accord is pragmatic; it is a product of the situation at hand. Each agency gave up something, as is appropriate -- indeed necessary -- in a successful negotiation. Each agency abandoned some of its claims to regulate the new products. The CFTC yielded its claim to exclusive jurisdiction over options on GNMA's, Treasury instruments, foreign currencies and CD's, as well as any right to approve futures on municipal securities and individual corporate securities. It gave up any right unilaterally to approve futures on groups and indices of securities, without regard to SEC concerns over manipulation. It also gave up its claim that the CEA pre-empted reporting and registration requirements under the securities laws, and its right to permit settlement in stock on a futures index.

The SEC yielded its claim that the CFTC could not authorize derivative products on any nonexempted securities, backed away from challenging the economic purpose of certain new products, and dropped its insistence that removal of regulatory disparities between the agencies be a pre-condition to CFTC approval of new products derivative of securities. In addition, by endorsing the accord, the SEC implicitly endorsed the reauthorization of the CFTC as an independent agency with only such changes to its charter as were necessary to give effect to the accord.

Beyond this give and take, the accord marks an unprecedented effort by two agencies to rationalize their overlapping jurisdictions in the interests of efficiency, accommodation and just plain "getting on with the job." This effort has opened lines of communication between the agencies. It has heightened their awareness of the growing interdependence of the nation's securities and futures markets. It has bred, not co-option, but cooperation. The agencies have joined in an enforcement action in Utah. They are having on-going discussions to develop cooperative surveillance techniques. And there have been discussions concerning the treatment of individuals seeking or holding market professional status under one agency's statutes who have violated the other's statutes.

Of course, the accord did not resolve all issues of concern to the agencies. The question of whether, and how, futures on individual nonexempt securities should be approved for trading was deferred for future study. And the regulatory differences under the agencies' statutory schemes were left untouched.

The agencies deferred the question of futures on individual corporate and municipal securities because they were unable to agree on the appropriate regulatory scheme to be employed. Particularly troublesome was the question of where authority over futures on corporate securities should reside, given the CFTC's traditional oversight role with respect to futures on the one hand, and the SEC's pervasive responsibilities with respect to the underlying securities on the other.

Both agencies recognize that a futures market for individual corporate securities could be utilized by investment bankers to hedge the risk of forward underwriting commitments, thereby enhancing their ability to offer fixed price underwritings at reasonable cost. Deferral of the development of this market is one cost of the accord, but a very modest cost, indeed, when weighed against the benefits.

The "hands off" policy toward the differences in regulation was simply a necessary condition to reaching the accord. It was, as we say, a "deal breaker." Perhaps here I should define my terms, even though I do not intend, today, to delve into the subject of "regulatory differences." In using this term, I intend to refer first to such major economic matters as differences in tax treatment and margin requirements for competing products. In these two cases, of course, the agencies themselves were not free to eliminate the differences, even if they were inclined to do so. Second, I am referring to the different regulatory approaches adopted by the agencies to deal with such matters as customer protection, conflicts of interest, insider trading, surveillance, enforcement and sanctioning. These differences may or may not have important economic consequences.

Whether the "hands off" policy toward these differences in regulation will prove to be a cost or benefit of the accord depends on how the future unfolds.

The Future

Looking, then, to the future, the most significant aspect of the accord is that it opens the way for competition among financial instruments across jurisdictional lines.

As earlier noted, the recent growth in trading of financial futures has been dazzling. With many new products in the pipeline, one can safely assume that, once the accord has been implemented, the growth in financial futures and options will continue apace. The profile of those using these markets is changing. Ten years ago, traders in the futures markets consisted almost entirely of commercial groups engaged in business-related hedging and a small number of professional speculators. Today, increasing numbers of non-professional hedgers and speculators are being attracted to the financial futures markets.

The Kansas City Board of Trade's booklet on its new Value Line Average stock index futures contract stresses the benefits of this product to all manner of investor, including "executors of estates, institutional investors, investment bankers, investors and holders of stock options, foreign investors and [even] small investors." This booklet also highlights the growing interdependence of the securities and futures markets. It promotes the product as a futures contract that:

"° Provides price insurance for equity positions.

° Affords an efficient method for trading the stock market.

° Creates a method for hedging stock options with a stock futures index, fully utilizing the synergism of the stock and stock options markets."

Competition is expected to develop among several types of products approved by the two agencies. Options on foreign currencies are a prime candidate for competition, since under the accord exactly the same products may be traded on the exchange markets regulated by the two agencies.

In addition, options on exempt securities, approved by the SEC, are expected to compete with futures contracts on those securities, as well as options on those futures contracts, approved by the CFTC. And options on broad-based stock groups and indices approved by the SEC will compete with futures contracts on such groups and indices approved by the CFTC.

The anticipated competition among financial instruments across jurisdictional lines will inevitably highlight the regulatory differences between the two agencies. Indeed, there is something of a paradox here. By clarifying and accommodating the jurisdictions of the SEC and the CFTC along pragmatic rather than logically functional lines, the

accord will increasingly accentuate the differences in regulatory approaches pursued by the two agencies. More importantly, since competing products will be subject to differing regulatory schemes, those differences will be counted among the competitive factors influencing the customer's choice. Thus, in relaxing one set of tensions, the accord has planted the seeds for another.

The inter-agency tension emerges from the potential conflict between each agency's natural tendency to want to see its exchange markets flourish in competition with others, and that agency's statutory mandate to protect the investing public.

Now, this tension could turn out to be a productive one. With lines of communication open, the agencies may benefit importantly from the opportunity to observe the effects of different regulatory approaches. One would hope that, through shared experience, the agencies would tend to adjust their regulatory schemes to adopt the most effective and least costly means of protecting the public and otherwise serving the public interest.

Of critical importance to this outcome, however, will be both an awareness of the inherent dangers of inter-agency competition and a dedicated effort to avoid falling prey to them. Examples of these dangers are easy to find. The multi-agency regulatory apparatus for banks is believed to foster what Arthur Burns, former Chairman of the Federal Reserve Board, has called "competition in laxity." As Chairman Burns put it to the American Bankers Association in 1974:

> "[T]he present system is conducive to subtle competition among regulatory authorities, sometimes to relax constraints, sometimes to delay corrective measures. I need not explain to bankers the well-understood fact that regulatory agencies are sometimes played off against one another."

This problem led Senator Proxmire to introduce legislation in 1975 and again in 1977 and 1978 to unify the three existing bank regulatory agencies into a single agency, thereby removing the incentive, as he put it, "to regulate all institutions at the lowest common denominator level. . . ."

In the field of state corporate law, Professor William Cary, a former Chairman of the SEC, has documented what he saw as a "race to the bottom", with Delaware the apparent winner.

It is interesting to note that sensitivity is already being shown to the danger that regulatory differences may become competitive factors. In its recent release proposing rulemaking to establish margin requirements for stock index futures contracts, the FRB noted that such contracts can compete with, and be an economic substitute for, stock options, on which margin requirements are currently imposed. This led the FRB to conclude that margin requirements on stock index futures may be appropriate not only to limit the use of speculative credit, but also to assure competitive equality among functionally similar instruments.

While recognizing these dangers of inter-agency competition, my own hunch is that the SEC and the CFTC will gradually evolve substantially similar regulatory approaches to address their common concerns in cost effective ways. Regulatory differences will be eroded where not justified by product or customer distinctions, but not at the expense of the investing public.

I hold to this essentially optimistic view for two reasons. First, significant competitive advantages derived from regulatory differences cannot last. They will prove intolerable. Second, my experience with these agencies suggests that each, motivated by the public interest and a congruent instinct for survival, will stand by its public trust, despite the temptation to resolve the differences through a "competition in laxity."