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**News
Release**

**The Exclusivity Clause of
the Commodity Exchange Act:
The New Glass-Steagall?**

Remarks of

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As members of the Bank Securities Association, you have a rather keen appreciation of the impact of legislation that establishes arbitrary restraints on competition. By separating commercial and investment banking, the framers of the Glass-Steagall Act sought to protect the stability of the U.S. market, as well as to prevent conflicts of interest and other real or potential abuses that had manifested themselves in the period leading up to the Crash of 1929 and its aftermath. Protecting market stability and investors against abuse, and protecting the federal safety net of deposit insurance backed by the taxpayers, are certainly important goals. They remain as important today as they have ever been.

Sometimes we develop an attitude that technology or other developments have made some traditional concerns less relevant, or somehow passe. However, it is probably safe to assume that human nature hasn't changed very much, and many of the same types of problems we have seen in financial markets of the past could reoccur absent sensible preventative measures. That is true whether we are concerned with market manipulation, or financial solvency.

While the "old concerns" of market stability and investor protection are in my opinion still critical responsibilities for government regulation, it is important to distinguish between regulatory programs that are tailored reasonably narrowly to achieve specific goals, and overbroad prohibitions on competition. Like using the proverbial elephant gun to kill a fly, prohibiting all market entry into a financial field like securities by all firms from a particular industry is an unnecessarily broad and restrictive approach.

Limiting the form of such participation to separately capitalized companies registered under the securities laws and not commingling their activities with their bank affiliates is a perfect example of how narrower restrictions can be developed to allow competition, yet still take realistic precautions against problems that could occur. Indeed, the overall approach of "functional regulation" is designed to allow competition irrespective of the type of company involved, but to insist on applying the same safety standards and other regulatory requirements to a broker-dealer, for example, irrespective of whether it is an independent firm or owned by a bank holding company.

After years of efforts to go over, under, around or through Glass-Steagall, the banking industry has now won access to relatively widespread participation in securities activities. Given that banking and securities activities are often virtually indistinguishable, that does not seem inappropriate, as long as

the risks of banking activities underwritten by the taxpayers are kept strictly separate from the losses of securities activities.

In fact, on March 26, 1991, a milestone in that process was reached when a registration statement covering 5,850,000 shares of common stock offered by Amsco International, Inc. was declared effective by the SEC. J.P. Morgan Securities, Inc. underwrote 422,500 shares of the total offering. This represents the first time in more than a half century that a commercial bank affiliate has been an underwriter of a public offering of equity securities. Senator Glass and Representative Steagall are probably still spinning.

Of course there are still numerous restrictions on the conduct of securities activities by banks. These restrictions make the business more costly, and less flexible, than it would otherwise be without them. In many cases, these restrictions also make the system safer and more fair than it might otherwise be if there were not limitations on the degree of intermingling of the bank's securities activities with the federally insured bank. Of course over time the conditions of such participation should be reassessed to make sure that unnecessary costs and restrictions are not imposed.

Despite the progress that has been made in allowing competition through changes to Glass-Steagall, the United States today stands close to adopting a new and potentially more far reaching barrier against financial competition. When Congress returns tomorrow from its recess, an effort will be made to bring S. 207, the CFTC Reauthorization Act, to the floor. Buried in a large and complex bill governing the operations of the CFTC under the agricultural laws, this bill contains provisions that, in my judgment, will have an enormously restrictive effect on the competitiveness of banks and securities firms by extending the reach of the "exclusivity clause" of the Commodity Exchange Act ("CEA").

The "exclusivity" provisions of the CEA provide that the CFTC shall have exclusive jurisdiction over transactions involving "contracts of sale for future delivery...", and that such contracts must be traded solely on a board of trade (futures exchange). The "exclusivity" provisions were adopted in 1974, at a time when the scope of the CEA was coverage of trading in contracts for wheat, pork and other agricultural or mineral products. Unfortunately the statute does not define "contracts...for future delivery", thereby creating significant ambiguity surrounding this critical term on which jurisdiction under the CEA turns.

The exclusivity clause was essentially adopted for two purposes. One was to bring under the coverage of the CEA trading in certain contracts that were already trading on futures

exchanges side-by side with contracts that were subject to the CEA. The other purpose was to preempt all state regulation of trading in futures contracts other than antifraud jurisdiction. This step recognized the enormous costs that duplicate state regulation in securities markets has caused.

Subsequent to the adoption of the exclusivity clause, the nation's futures exchanges began trading in futures contracts on a variety of financial instruments, including Treasury securities, currencies and stock indexes like the Standard and Poors 500. Futures contracts on underlying instruments from the banking, securities and insurance industries are now widely traded, and futures on financial instruments now represent by far the largest volume of the futures exchanges.

Shortly after commencing trading in financial futures, the Chicago Mercantile Exchange ("CME") and the Chicago Board of Trade ("CBOT") brought the first of several lawsuits alleging that various financial products could not be offered or traded by other types of competitors, including the nation's securities exchanges. In one early case, these exchanges sought to prevent trading in options on securities of the Government National Mortgage Association ("GNMA") based on the exclusivity clause, notwithstanding the fact that the underlying GNMA instruments were unequivocally securities, and that Congress has provided for the regulation of trading in options on securities by securities exchanges since 1934. Following a decision of the Seventh Circuit in 1982 prohibiting trading in options on GNMA's, Congress revised the law to overturn that decision.

At base what is at stake in the application of the exclusivity clause is the principle of competition among financial instruments and providers. Indeed, U.S. financial markets have long been the most innovative in the world largely because national policy has consistently sought to foster competition, and to prevent any single regulatory agency from having the regulatory power to insulate any particular type of firm or exchange from competition by those who develop completely new types of products, or simply new variants of existing instruments.

The interplay of banking and securities markets provides an excellent example of the benefits of such competition. Traditional federal regulation of interest rates on bank deposits resulted in negative real returns on savings during the period of high levels of inflation in the late 1970s. To provide consumers with a market rate instrument similar to the convenience of a bank checking account, but without federal deposit insurance or federal interest rate controls, the money market fund was developed by the mutual fund industry. Starting from virtually negligible assets, money market funds now have more than 20 million accounts and hold approximately \$500 billion in public

savings.

However, if federal banking laws had contained a provision to the effect that all products containing any attribute of a bank deposit had to be offered exclusively by banks subject to the regulation of a federal banking agency, then the money market fund would not have survived suits by banks against these products being offered to the public. As a result, there would not be any money market funds today, and tens of millions of consumers would have been denied the opportunity to invest in this product.

In addition to the money market fund, a "bank exclusivity clause" could have prevented or seriously impeded the development of commercial paper, which contains many attributes of a short-term loan. Today that market is one of the most important sources of liquidity and working capital for both large and small companies at rates that are often considerably lower than comparable maturity bank credits would cost. This lowers the cost of operating capital for businesses nationwide, but it would not have been possible if there had been an exclusivity clause. Also, securities that pool underlying bank loans of various types, like collateralized mortgage obligations or pass-through instruments for many types of receivables probably could not have been developed and offered if there had been a statute that created "exclusive jurisdiction" for any bank regulator.

If federal securities laws contained a clause providing that instruments involving a security could only be offered under the securities laws and subject to the regulation of the SEC, many major products of banks, insurance companies and futures exchanges might not exist today. Certainly "discount brokerage" offered by banks would not have been possible, notwithstanding the convenience to bank customers of this type of service. Bank collective and common trust funds also might not have been allowed, or many types of single premium and variable rate annuities. If the federal securities laws provided for "exclusive" jurisdiction, many types of financial futures might have been unlawful and restrained from trading under suits by securities exchanges.

In all of these cases, and many others, financial firms from the banking, securities, insurance and commodities industries have responded to the needs of their existing or potential customer bases by producing products to meet particular financial needs. Many of these products are structured to provide particular types of returns, to meet certain types of risk (credit risk, interest rate risk, market risk, etc.), to take advantage of unique tax provisions, to provide certain types of conveniences, or to respond to customer needs in a variety of other ways. Most of the time we wisely leave the creation of these new products to the dynamics of the marketplace, rather

than the vagaries of the courthouse.

Competitive pressures force providers of a particular type of product to be efficient, and to provide that product at attractive prices, precisely because other types of firms will be free to structure competitive products under different regulatory systems (banking, securities, insurance or futures). The result is, in most cases, innovation and lower cost capital. It is also critical to maintaining the attractiveness of U.S. financial markets in the face of steadily intensifying competition from foreign markets and firms.

The extremely damaging long-run risk of the exclusivity clause comes from a simple fact. Chairman Alan Greenspan of the Federal Reserve clearly enunciated this risk when he noted in a recent letter to the late Senator John Heinz that all financial instruments involve some degree of futurity:

"Interpreted broadly, any financial contract has some element of futurity; hence this provision potentially affects a wide range of existing and new financial products that might be offered outside of the futures exchanges, including some depository instruments..."

Because every financial product involves some degree of futurity, and some degree of "risk shifting", the literal application of the exclusivity clause could result in significant interference with the structuring of financial products to meet the needs of customers, as opposed to meeting the intricacies of federal agricultural laws. In fact, the exclusivity clause has already had precisely that type of effect.

The destructive power of the exclusivity clause was vividly demonstrated in the so-called "IPs" case. The "Index Participation" was a new product developed by securities exchanges to allow customers to participate in the benefits of an index of stocks, rather than an individual security. In that sense, the IP was like a stock index futures contract. However, if an IP was precisely like a stock index future, it might not have had much of a market. However, the IP was structured to appeal to individual investors, rather than institutions.

Indeed, it is worth noting that the stock index futures market is almost entirely an institutional market. Only a small percentage of trading in stock index futures on the CME is trading by traditional retail investors, who make up an enormous part of the participation in the nation's securities markets. There may be many reasons for the unwillingness of investors to participate directly in futures markets.

Among other things, participants in these markets do not have most of the traditional protections of the securities laws

against fraud and various types of customer abuse. For example, while insider trading is a serious violation of the securities laws, it is an accepted part of business on the nation's futures exchanges. Indeed, the CFTC has vigorously resisted suggestions from one of its own members that trading on inside information ought to be prohibited in futures markets. Participants in futures markets also lack the benefit of "suitability" rules, and many other traditional protections of the securities laws for the retail investor.

Irrespective of the reason, however, it is a fact that the stock index futures market is an institutional market with extremely limited direct investor participation. To appeal to individual investors rather than institutions, the IPs developed by the securities exchanges had features such as perpetual rather than limited life (like the perpetual life of a common stock), and dividend-equivalent payments by the seller of the IP (like the dividends on common stocks).

The IP was developed by securities exchanges to offer their retail customers the ability to invest in a basket of stocks rather than single stocks, without the need for management fees for a managed product like a mutual fund. The SEC unanimously voted to license the IP for trading on securities exchanges, and in only four months more than 74 million IPs were sold. This rapid success in the marketplace demonstrated that the stock index futures contract was not fully serving the marketplace. Presumably the purchasers of the IPs saw something in them that they did not see in the standard stock index futures contract. Despite their carefully cultivated image of advocating free markets, the CME and CBOT brought suit against the SEC to prevent the securities exchanges from trading IPs. They didn't trade IPs then, and they don't today, but evidently they didn't want their competitors to be able to offer the product they weren't planning to offer.

After thoroughly reviewing the characteristics of the IPs, the Seventh Circuit Court of Appeals found that the IP was not a pure security or a pure futures contract, but that it contained elements of both a security and a future. Indeed, the Court correctly noted that the IP was specifically designed to be a new "hybrid" product, rather than simply a copy of something already available in the marketplace.

Sadly, the Court concluded that the literal language of the exclusivity clause applied whenever the CFTC decides that an instrument has some of the elements of a future. As a result, the Court ruled that IPs could not be offered to American investors, and struck them from the marketplace. In so doing, the Court observed that the current law and its decision "doubtless...gives the futures markets the opportunity to block competition from an innovative financial product." Today the

only place that a product similar to the IP can be purchased is on the Toronto Stock Exchange.

The result of the IPs case led the Administration to propose legislation last year that would have sharply narrowed the exclusivity clause. In framing its legislation, the Bush Administration correctly recognized that far more than one single product, no matter how useful, was at stake. Rather, what is at stake in the issue of exclusivity is the freedom and ability to compete and to innovate in the U.S. capital market. If the CEA is now to be read as providing that any instrument with elements of futurity may be considered to be a futures contract and therefore required to be traded on futures exchanges, the law will block development of new products in numerous financial markets given that all financial products contain some degree of futurity.

At the end of the last Congress, a "Compromise Bill" was developed by Senators Dodd, Heinz, Bond, Leahy and Lugar. That legislation dropped the Administration's proposal to transfer jurisdiction over stock index futures to the SEC, but it provided for the oversight of futures margin practices by the Federal Reserve, and it substantially reduced the scope of the exclusivity clause. In testimony during February of this year before the Senate Agriculture Committee, the Administration refused to endorse the Compromise Bill because it did not go as far as the Administration's own legislation. The SEC and the Federal Reserve supported the Compromise Bill, while the CFTC opposed any limitation on exclusivity and any federal oversight of margins.

Following the hearing on the Compromise Bill, the provisions of S. 207 were radically altered. Instead of restricting the applicability of the exclusivity clause to banking, securities, and other products, the legislation as marked up by the Committee appears to embrace the most sweeping possible interpretation of the scope of the exclusivity principle. By containing elaborate provisions authorizing (but not requiring) the CFTC to exempt bank accounts, swap transactions and certain other products under certain narrow circumstances, the bill unavoidably creates the view that such products are within the scope of the agriculture laws -- since otherwise no exemption would be necessary.

If this principle becomes codified as a matter of federal statute, then the implications for U.S. financial markets will be seriously adverse. Since many "hybrid" products could not be traded on a futures exchange even if their issuers wanted to do so (because they are company-specific, for example, or are designed for a retail investor), a requirement that such products may only be traded on a futures exchange is in reality a flat bar of that product from being offered in the United States at all. Like the IPs, these products will be destroyed, and any other

product as to which a question is even raised will be subjected to substantial uncertainty, delay in approval, and enormous regulatory cost.

Indeed, there is no indication from S. 207 how long the CFTC may take to decide whether to allow new banking products to be offered, for example. Their review of an exemptive request may take six months, or it may take six years. No hearing on the new language of S. 207 has ever been held. Indeed, some of the specific provisions were literally drafted during the middle of the night prior to the Committee's action.

In many respects, this legislation is exactly the opposite of good regulatory policy. Rather than starting from a presumption that new products are legal unless the regulator of the type of company offering the product concludes that they may not be offered for some identifiable reason of public safety or market stability, this legislation is based on the premise that all products not listed on a futures exchange are unlawful until the CFTC affirmatively acts to give them an exemption. Thus, while an accused felon is innocent until proven guilty, a new financial product allegedly containing "futuraity" is guilty until proven innocent.

In its current form, this legislation is in effect a new "Glass-Steagall" Act. The result will be protracted regulatory proceedings, frequent litigation, and enormous regulatory cost. Substantial opportunities to offer new types of products in the U.S. market will be foreclosed. Financial activity in swaps and many other products will be forced to offshore markets. Companies that might derive a lower cost of capital from a hybrid instrument will be forced to do such financings abroad in many cases, thereby harming the future vitality of the U.S. securities exchanges.

Ironically, I am not aware of any public policy argument whatsoever for creating such expense and uncertainty in the market. Making the current monopoly trading privileges of the futures exchanges more perfect is hardly a satisfactory basis for national legislation. Even if one accepts the view of the CFTC that granting it enormous new discretionary power to license new products is an improvement over current law, there has not been any explanation of why we cannot develop "exclusivity" provisions that are far more tolerant of experimentation and competition.

The "exclusivity" provisions should ideally be abolished outright as they apply to the offering or trading of products under any other established system of financial regulation where public protection and market integrity are achieved through established safeguards. Extension of this principle to bar competition where market safety and protection of investors are not at stake would be tragic and senseless.