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Report to Congressional Requesters

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CFTC AND SEC

Issues Related to the Shad-Johnson Jurisdictional Accord

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The Honorable Richard G. Lugar
Chairman, Committee on Agriculture,
Nutrition and Forestry
United States Senate

The Honorable Thomas W. Ewing
Chairman
Subcommittee on Risk Management,
Research, and Specialty Crops
Committee on Agriculture
House of Representatives

The Honorable John D. Dingell
Ranking Member
Committee on Commerce
House of Representatives

To clarify their respective jurisdictions over securities-based derivatives,[1] the Securities and Exchange Commission (SEC) and Commodity Futures Trading Commission (CFTC) reached an agreement, called the Shad-Johnson Jurisdictional Accord, in 1981. The accord was enacted into law in January 1983 and, among other things, prohibited futures[2] trading on single stocks, as well as on stock indexes that did not meet specific requirements. These prohibitions reflected concerns that such futures could be used as substitutes for single stocks to circumvent securities laws and regulations. Given your interest in ensuring that the U.S. financial markets remain innovative, competitive, and, at the same time, appropriately regulated, you asked us to review certain issues related to the accord trading prohibitions. In response, we analyzed

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[1] Derivatives are contracts that have a market value determined by the price of an underlying asset, reference rate, or index (called the underlying). Underlyings include stocks, bonds, agricultural and other physical commodities, interest rates, foreign currency rates, and stock indexes.

[2] Futures are agreements that obligate the holder to buy or sell a specific amount or value of an underlying asset, reference rate, or index at a specified price on a specified date. These contracts may be satisfied by delivery or by offset with another contract.

- the extent to which U.S. securities, foreign futures, and over-the-counter (OTC)[3] markets trade stock-based derivatives that are economically similar to the futures prohibited from trading by the accord;
- the potential effect of the accord trading prohibitions on derivatives market participants;
- concerns about calls to repeal the accord trading prohibitions; and
- jurisdictional and other approaches to addressing these concerns.

Results in Brief

U.S. securities, foreign futures, and OTC markets trade derivatives that are based on single stocks and stock indexes. However, the Shad-Johnson Jurisdictional Accord precludes U.S. futures exchanges from trading futures on single stocks and certain stock indexes. The stock-based derivatives that are trading in other markets can be used, like futures, to hedge (i.e., shift the risk of price changes to those more willing or able to assume the risk) or to speculate (i.e., invest with the intent of profiting from price changes). Specifically, U.S. securities exchanges trade options[4] on over 2,600 single stocks. These options can be used to replicate the economic function of single stock futures. U.S. securities exchanges also trade options on a wide range of narrow-based stock indexes.[5] In addition, 9 foreign exchanges trade single stock futures on at least 189 foreign stocks. In 1998, about 2.1 million single stock futures were traded, accounting for less than 1 percent of the total trading volume of the foreign futures market. Finally, the OTC derivatives market offers equity swaps[6] that serve economic functions similar to futures and that can be structured using virtually any single stock or stock index. As of year-end 1998, the equity swaps market worldwide had an estimated total notional value of $146 billion, accounting for a fraction of a percent of the total notional value of the OTC derivatives market worldwide.

[3] The OTC market offers contracts that are privately negotiated outside of organized exchanges.

[4] Options contracts are derivatives that give the purchaser the right to buy (call option) or sell (put option) a specified quantity of an underlying asset, reference rate, or index at a particular price (the exercise price) on or before a certain future date.

[5] Narrow-based stock indexes generally are indexes that represent stocks in a single industry or a group of related industries.

[6] Equity swaps are OTC derivatives that have a market value determined by the price of a single stock or stock index. Swaps are privately negotiated contracts that typically require counterparties to make periodic payments to each other for a specified time period. The calculation of these payments is based on an agreed-upon amount, called the notional amount, that typically is not exchanged.

The accord trading prohibitions may have limited investor choice and exposed some market participants to legal uncertainty. Although investors can use stock-based options and equity swaps to hedge price risk, they cannot use stock-based futures to the same extent because of the accord prohibitions on single stock and certain stock index futures. Also, some futures industry officials have said that the accord prohibitions should be repealed, because they have restricted U.S. futures exchanges from competing with other markets that trade derivatives on single stocks and narrow-based stock indexes. Additionally, other futures industry officials said that the accord has limited the ability of U.S. investors to use foreign exchange-traded stock index futures to hedge risks associated with their foreign stock investments. Finally, the accord has exposed equity swaps counterparties to legal uncertainty. If an equity swap falls within the judicially crafted definition of a futures contract, it would be in violation of the accord, making it illegal and unenforceable.

In response to calls to repeal the accord trading prohibitions, SEC, the U.S. securities exchanges, the President's Working Group on Financial Markets (Working Group),[7] and several members of Congress have expressed concerns about doing so without first resolving applicable differences between securities and commodities laws and regulations. Their concerns center on the potential for single stock and certain stock index futures to be used as substitutes for single stocks to circumvent federal securities laws and regulations. The most significant differences identified were the lack of comparable insider trading prohibitions, margin[8] levels, and customer protection requirements. CFTC and futures exchange officials have agreed that the lack of comparable insider trading prohibitions would need to be addressed so that stock-based futures could not be used to circumvent the insider trading prohibitions of the federal securities laws that are lacking in the Commodity Exchange Act (CEA). Also, while CFTC and the Federal Reserve have recognized that the U.S. futures exchanges have a record of setting margins at levels that have protected the financial integrity of the markets, futures exchange officials have said that they would be willing to set margin for single stock futures at a level comparable to margin for single stock options. Additionally, SEC and the U.S. securities exchanges disagree with the National Futures Association

[7] The Working Group is composed of the Secretary of the Treasury, the Chairman of the Board of Governors of the Federal Reserve System, the Chairman of SEC, and the Chairman of CFTC.

[8] Margin refers to funds that are deposited with a securities broker or futures commission merchant in conjunction with stock, options, or futures transactions.

(NFA)[9] on whether customer protection requirements for the securities and futures markets offer similar protections. Finally, other differences between the securities and commodities laws and regulations exist, such as restrictions on short-term profits by corporate insiders, that would need to be resolved, if the accord prohibitions are to be lifted.

Pivotal to addressing legal and regulatory concerns related to repealing the accord trading prohibitions is resolving the jurisdictional question of whether SEC, CFTC, or both agencies should regulate futures on single stocks and certain stock indexes. The answer to this question would determine whether such futures were regulated under the securities and/or the commodities laws and, in turn, would affect the type of legal and regulatory changes that would be needed. According to SEC and securities exchange officials, the prohibited futures could be allowed to trade, if they were regulated as securities. These officials said that such an approach would enable SEC to ensure that stocks and stock-based derivatives were regulated consistently. According to futures exchange officials, if the prohibited futures were allowed to trade, they could be effectively regulated under the CEA. These officials said that, under this approach, the CEA could be amended and other steps taken to address SEC and U.S. securities exchange concerns.

In response to congressional requests for action, SEC and CFTC have tentatively agreed to an approach that would allow single stock futures to be traded on both U.S. securities and futures exchanges. Under this approach, the agencies would jointly regulate such futures, the intermediaries that offered them, and the markets that traded them. In reaching their tentative agreement, SEC and CFTC noted the importance of avoiding the imposition of unnecessarily burdensome or duplicative regulation on the securities and futures markets as well as on their participants. Although the agencies have tentatively agreed on the initial standards for trading single stock futures, they have not yet agreed on which core provisions of the securities and commodities laws would apply to the markets and intermediaries. SEC and CFTC officials said that one of their major challenges is developing a process to ensure that regulations applicable to the securities and futures markets and intermediaries remain consistent and appropriate as the markets evolve. These officials said that the agencies plan to continue working together with the goal of providing a comprehensive legislative proposal to Congress before it adjourns.

[9] NFA is a self-regulatory organization that is responsible, under CFTC oversight, for qualifying commodity futures professionals and for regulating the sales practices, business conduct, and financial condition of its member firms.

The SEC and CFTC joint approach for addressing the issues surrounding the trading of the prohibited futures as well as other approaches indicate that such issues are resolvable. While SEC and CFTC have begun working together to address these issues, uncertainty remains about the outcome of such efforts because of differences between the SEC and CFTC perspectives as well as the securities and commodities laws. Continued congressional attention may be a key factor in the ultimate resolution of the jurisdictional issues involved. As a result, we are recommending that SEC and CFTC (1) work together and with Congress to develop and implement an appropriate legal and regulatory framework for allowing the contracts to trade and (2) submit to Congress legislative proposals for repealing the accord trading prohibitions.

Background

In the United States, SEC has authority over securities trading and the securities markets, and CFTC has authority over futures trading and the futures markets. According to SEC and CFTC, three amendments to the CEA in 1974 led to jurisdictional disputes over securities-based futures. First, the act was amended to expand the definition of a commodity to include virtually anything—tangible or intangible. Consequently, a security fell within the definition of a commodity. Second, the act was amended to provide CFTC with exclusive jurisdiction over all commodity futures transactions, including options on futures. Third, the act was amended to preserve SEC's preexisting authority over securities trading and the securities markets.

These three CEA amendments led to a dispute between SEC and CFTC that was eventually resolved through the Shad-Johnson Jurisdictional Accord. In 1975, CFTC approved a Chicago Board of Trade (CBT) application to trade futures on Government National Mortgage Association pass-through mortgage-backed certificates. In an exchange of letters, SEC asserted that the contracts were securities within its jurisdiction, and CFTC responded that they were futures within its exclusive jurisdiction. The dispute remained unresolved, and in 1981, SEC approved rule changes for the Chicago Board Options Exchange (CBOE) that allowed the exchange to trade options on the certificates. CBT petitioned the U.S. Seventh Circuit Court of Appeals to set aside the SEC order. The court prevented CBOE from trading the options until it could render its decision.[10] Under these circumstances, SEC and CFTC reached the accord to clarify their respective jurisdictions over securities-based options and

[10] In Board of Trade of the City of Chicago v. Securities and Exchange Commission, 677 F. 2d 1137 (7th Cir. 1982), the Seventh Circuit Court of Appeals subsequently found that SEC lacked the authority to approve CBOE to trade the options, because the options fell within CFTC's exclusive jurisdiction.

futures. In February 1982, they submitted the accord to Congress to be enacted into law. Congress codified the accord substantially as proposed in the federal securities laws as section 2 of the Securities Act of 1933 and section 3 of the Securities Exchange Act of 1934 and in the CEA as section 2(a)(1)(B).[11]

The accord allocated jurisdiction between SEC and CFTC for, among other things, securities-based options and securities-based futures and options on futures.[12] First, it provided SEC with jurisdiction over securities-based options, including stocks and stock indexes. Second, the accord prohibited futures (and options thereon) on single corporate and municipal securities. According to SEC and CFTC, the ban was intended to be temporary, and both agencies were to complete a study of the accord with a view toward lifting the prohibition. SEC officials told us that the study was to be undertaken 5 years after the accord was reached. But, according to the officials, it was never done because of the need to complete higher-priority studies following the 1987 and 1989 market declines.

Finally, the accord provided CFTC with jurisdiction over futures (and options thereon) on exempted securities[13] (other than municipal securities) and stock indexes. The accord allowed CFTC to approve a stock index futures contract for trading if CFTC found that the contract was (1) settled in cash; (2) not readily susceptible to manipulation; and (3) based on an index that either was a widely published measure of and reflected the market as a whole or a substantial segment of the market, or else was comparable to such a measure. According to SEC and CFTC, these three standards were intended to ensure that stock index futures would not be readily susceptible to manipulation, be used to manipulate the underlying securities or related options markets, or serve as a surrogate for a single stock futures contract.

The one substantial change that Congress made to the accord in codifying it was to provide SEC with veto authority over stock index futures. As submitted to Congress, the accord would have only required that CFTC consult with SEC before approving a stock index futures contract; it would not have provided SEC with veto authority over such contracts. As

[11] The accord was codified in the Securities Act Amendments of 1982, which amended the federal securities laws, and the Futures Trading Act of 1982, which amended the CEA.

[12] The accord also clarified SEC and CFTC jurisdiction over options and futures on, among other things, certificates of deposit and foreign currencies.

[13] Exempted securities include securities issued or guaranteed by the United States, the District of Columbia, or any U.S. state.

codified by Congress, the accord required CFTC to provide SEC with an opportunity to review any proposed stock index futures contract before approving it for trading. If SEC determined that the proposed contract failed to meet the accord standards, CFTC could not approve the contract.[14] According to the accord's legislative history, Congress included this provision to provide SEC an equal voice with CFTC "in making certain threshold determinations about the manipulative impact" of a stock index futures contract. Under this arrangement, CFTC had approved 57 stock index futures contracts for trading as of January 12, 2000.

Scope and Methodology

To address each of our four objectives, we reviewed the legislative history of the accord, congressional hearings, federal securities and commodities laws and regulations applicable to stock-based derivatives, and legal cases involving the accord, as well as studies and articles on the regulation and economic function of the securities, securities options, and futures markets. In addition, to analyze the extent to which U.S. securities, foreign futures, and OTC markets trade stock-based derivatives that are economically similar to the futures prohibited from trading by the accord, we collected and analyzed trading and related data on U.S. securities options, foreign single stock futures, and equity swaps. To analyze concerns about calls to repeal the accord trading prohibitions, we also attended congressional briefings by CFTC, SEC, U.S. futures and securities exchanges, and industry associations in which they presented their views on the legal and regulatory concerns associated with repealing the accord prohibitions. To analyze jurisdictional and other approaches to addressing these concerns, we reviewed the SEC and CFTC March 2, 2000, letter to selected congressmen that presented their joint approach for allowing the trading of single stock futures in both U.S. securities and futures markets.

In addition, to address each of our four objectives, we interviewed officials of CFTC; SEC; the Federal Reserve; three U.S. futures exchanges (CBT, the Chicago Mercantile Exchange (CME), and the New York Mercantile Exchange), which are self-regulatory organizations;[15] two U.S. securities exchanges (CBOE and the New York Stock Exchange) and the National

[14] The accord afforded futures exchanges an opportunity for a hearing on the record before SEC and judicial review in cases where SEC determined that a proposed futures contract failed to meet the accord standards.

[15] Self-regulatory organizations are private membership organizations that are given the power and responsibility under federal law and regulations to adopt and enforce rules of member conduct. Self-regulatory organizations play an extensive role in the regulation of the U.S. futures and securities industries and include all of the U.S. futures and securities exchanges, NFA, and the National Association of Securities Dealers.

Association of Securities Dealers,[16] which are self-regulatory organizations; two other industry self-regulatory organizations (the National Association of Securities Dealers Regulation and NFA); four industry associations (the Futures Industry Association (FIA),[17] International Swaps and Derivatives Association,[18] Securities Industry Association,[19] and U.S. Securities Markets Coalition);[20] and two market observers (a former CFTC chairperson and an expert in securities law). We also interviewed officials of two foreign regulatory authorities (the Swedish Financial Supervisory Authority and U.K. Financial Services Authority), two foreign exchanges (the London International Financial Futures and Options Exchange and OM Stockholm Exchange), and two foreign companies (Ericsson and Nordbaken) whose stock is subject to futures trading, to discuss their experiences, as applicable, with trading and regulating single stock futures. We included Sweden in our review because it had one of the most active markets in individual stock futures. We included the United Kingdom in our review because it did not prohibit single stock futures from trading and because it had recently adopted a single regulator for its futures and securities markets. Information on foreign law in this report does not reflect our independent legal analysis, but rather is based on interviews.

We requested comments on a draft of this report from the heads, or their designees, of CFTC, SEC, the Department of the Treasury, and the Federal Reserve Board. We also requested comments from CBT, CME, FIA, the International Swaps and Derivatives Association, NFA, the New York Stock Exchange, the Securities Industry Association, and the Securities Markets Coalition. SEC provided us with written comments, which are discussed near the end of this letter and reprinted in appendix I. In discussions held in March 2000, the General Counsel of CFTC; a financial economist of the Department of the Treasury; an assistant director of the Federal Reserve Board; and the Chief Counsel of the Division of Market

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[16] Although the National Association of Securities Dealers and its subsidiary, the NASDAQ Stock Market, are not registered securities exchanges, for simplicity we include them in our references to the U.S. securities exchanges in the remainder of this report.

[17] FIA is the national trade association of the futures industry.

[18] The International Swaps and Derivatives Association is a trade association that represents financial institutions worldwide. Its members include investment, commercial, and merchant banks that deal in OTC derivatives contracts.

[19] The Securities Industry Association is the national trade association of the securities industry.

[20] The U.S. Securities Markets Coalition is composed of the American Stock Exchange, Boston Stock Exchange, Chicago Stock Exchange, CBOE, Cincinnati Stock Exchange, NASDAQ Stock Market, National Securities Clearing Corporation, Pacific Stock Exchange, Philadelphia Stock Exchange, and Options Clearing Corporation.

Regulation, SEC, provided us with oral comments. Similarly, in discussions held in March 2000, officials of CBT, FIA, the New York Stock Exchange, the Securities Industry Association, and the Securities Markets Coalition provided us with comments. We did not receive comments from CME, the International Swaps and Derivatives Association, and NFA. The technical comments that we received were incorporated in the report as appropriate. The substantive comments that we received are discussed near the end of this letter. We did our work in Chicago, IL; London, England; New York, NY; Stockholm, Sweden; and Washington, D.C., between July 1999 and March 2000 in accordance with generally accepted government auditing standards.

U.S. Securities, Foreign Futures, and OTC Markets Trade Stock-Based Derivatives

Domestic and foreign markets trade derivatives on single stocks and stock indexes that have been precluded from futures trading in the United States under the accord. U.S. securities exchanges trade options on single stocks. They also trade options on a wide range of narrow-based stock indexes. Additionally, some foreign exchanges trade futures on single stocks. Finally, the OTC derivatives market offers equity swaps on single stocks and narrow-based stock indexes. Securities-based options, foreign stock futures, and equity swaps serve similar economic functions as would be served by the futures prohibited from trading under the accord.

U.S. Securities Exchanges Trade Options on Single Stocks

U.S. securities exchanges, which are regulated by SEC, trade options on single stocks that meet certain minimum requirements related to, among other things, the number of shares outstanding, number of shareholders, and trading volume. SEC first allowed exchange-traded options on single stocks when it approved CBOE as a national securities exchange in 1973. As of March 10, 2000, CBOE and three other securities exchanges—the American Stock Exchange, Pacific Stock Exchange, and Philadelphia Stock Exchange—collectively traded options on over 2,600 single stocks. In 1998, the trading volume in single stock options totaled nearly 326 million contracts, accounting for about 81 percent of total U.S. options trading volume.

Options on single stocks serve similar economic functions as would be served by futures on single stocks. For example, both products could be used to protect a stock position from a decline in price, or to speculate on an anticipated price change in the stock. Although options and futures serve similar economic functions, they differ in some ways, including their risk/return profiles.[21] Thus, it can be advantageous to use one product

[21] The buyers and sellers of futures contracts, like the sellers of options contracts, are exposed, in some cases, to unlimited risk of loss from an adverse price change. In contrast, the buyers (but not the

instead of the other, depending on the particular circumstances and preferences of the user. In addition, options on single stocks can be used to replicate prohibited futures on single stocks. For example, by buying a call option[22] on a single stock and selling a put option[23] on the same stock, a single stock futures contract can be created synthetically. Futures exchange officials said, however, that single stock futures could be more efficient and less costly than synthetic futures, because they involve one futures transaction instead of two options transactions. According to CBOE officials, the extent to which single stock options are used to create synthetic stock futures cannot be accurately estimated.

U.S. Securities Exchanges Trade Options on Narrow-Based Stock Indexes

U.S. securities exchanges trade options on a wide range of narrow-based stock indexes, which represent stocks in a single industry or a group of related industries. These options are subject to more stringent regulatory requirements, such as higher margins and lower position limits,[24] than are options on broad-based stock indexes.[25] As of March 10, 2000, SEC had approved the American Stock Exchange, CBOE, and the Philadelphia Stock Exchange to trade options on at least 59 narrow-based stock indexes. These indexes are composed of securities representing a single industry or sector, such as airline, Internet, and biotechnology companies. In 1998, the securities exchanges traded over 5 million narrow-based stock index options, accounting for around 1 percent of the total U.S. options trading volume.

Stock index options and stock index futures serve similar economic functions and can compete with and complement each other. These products can be used for hedging or speculative purposes. Given their similar economic functions, they can be used as substitutes in some cases. For example, either the Standard & Poor’s 500 index options or its futures contract—two of the most actively traded stock index options and

sellers) of options contracts are exposed to risk of loss that is limited to the amount of the premium paid for the contracts.

[22] A call option (American style) is a contract that gives the purchaser the right, but not the obligation, to buy a specified quantity of the underlying asset, reference rate, or index on or before a specified date at a price fixed at the initiation of the contract.

[23] A put option (American style) is a contract that gives the purchaser the right, but not the obligation, to sell a specified quantity of the underlying asset, reference rate, or index on or before a specified date at a price fixed at the initiation of the contract.

[24] Position limits are imposed by the exchange and limit the number of options contracts that any person, or persons acting in concert, may hold on the same side of the market.

[25] Broad-based stock indexes generally are indexes that represent the market as a whole or a group of stocks in unrelated industries.

futures[26] —can be used to protect stock holdings from a decline in price, or to benefit from a rise or fall in the stock market. In addition, stock index options and stock index futures can serve a complementary function. For example, market participants can use stock index futures to hedge risk related to their stock index options positions and vice versa. More specifically, a market participant using Standard & Poor's 500 index options to take a position that gains when the market falls can hedge that position by using Standard & Poor's 500 index futures to take a position that gains when the market rises.

Some Foreign Exchanges Trade Single Stock Futures

Some foreign exchanges, including Sweden's OM Stockholm Exchange, trade futures on single stocks, but trading volume in these futures has been relatively low. Although foreign exchanges trade single stock futures, the accord prohibits them from selling such futures to U.S. customers.

Some Foreign Exchanges Trade Single Stock Futures, But Trading Volume Is Relatively Low

Some foreign futures and/or stock exchanges have been trading futures on single stocks since at least 1988. According to data compiled by CBT and FIA, 9 foreign exchanges[27] trade single stock futures on over 189 stocks. In contrast to the United States, in at least five of these countries, the regulator that oversees the futures market also oversees the stock market. The existence of a single regulator in these countries may have facilitated the introduction of futures on single stocks in their markets.

In 1998, the trading volume in foreign single stock futures totaled about 2.1 million contracts and accounted for less than 1 percent of the total trading volume of the foreign futures market. The Helsinki Stock and Derivatives Exchanges, Bolsa de Derivados do Porto, and OM Stockholm Exchange accounted for around 96 percent of the total trading volume in single stock futures.

We visited the OM Stockholm Exchange, which was created through a 1998 merger between the OM Exchange and the Stockholm Stock Exchange. The OM Exchange began trading futures on single stocks in 1988, after being created in 1985 to electronically trade options on single stocks. According to exchange officials, the principal reason that the

[26] In 1998, CBOE traded about 25.7 million options contracts on the Standard & Poor's 500 index, while CME traded about 31.4 million futures contracts on the same index. The CBOE and CME contracts are not entirely comparable, because the CBOE contract is based on the amount of the index times $100, while the CME contract is based on the amount of the index times $250.

[27] The nine exchanges are the Budapest Stock Exchange (Hungary), Bolsa de Derivados do Porto (Portugal), FUTOP Clearing Centre (Denmark), Helsinki Stock and Derivatives Exchanges (Finland), Hong Kong Futures Exchange (Hong Kong), Mexican Derivatives Market (Mexico), OM Stockholm Exchange (Sweden), South African Futures Exchange (South Africa), and Sydney Futures Exchange (Australia).

exchange listed single stock futures was to compete directly with the Stockholm Stock Exchange by offering stock substitutes. The officials added that single stock futures would also complement stocks and options by providing an additional means for hedging stock and options positions.

According to officials of Sweden's Financial Supervisory Authority,[28] the Stockholm Stock Exchange initially opposed the OM Exchange's trading of single stock options and, to a lesser extent, single stock futures, because it viewed the trading of such products as a competitive threat. According to these officials, the conflict between the stock and futures exchanges subsided after 2 to 3 years, in part because options trading led to an increase in trading volume for stocks. They added that the conflict between the exchanges effectively ended in 1998, when the OM Exchange purchased and merged with the Stockholm Stock Exchange.

According to OM Stockholm Exchange officials, the exchange offered single stock futures based on the belief that if the underlying stock market could support trading in single stock options, it could also support trading in single stock futures. However, the exchange has had limited trading of single stock futures compared with single stock options. For example, in 1998, the exchange traded about 533,500 single stock futures compared to about 20.6 million single stock options. Although single stock futures trading volume represented about an 85 percent increase over the previous year, it accounted for about 1 percent of the total derivatives trading volume of the OM Stockholm Exchange.

The OM Stockholm Exchange officials said that single stock futures are not actively traded for at least two reasons. First, exchange members do not market these products to retail customers, in part because doing so would reduce the revenue they earn from selling stocks. Brokers earn commissions and interest from stocks purchased on margin; with futures, they earn only commissions. Moreover, brokers are cautious about selling futures to customers because of their risk of unlimited loss. Second, market makers and other professionals use single stock futures to hedge, but only to a limited extent because cheaper hedging alternatives are

[28] The Financial Supervisory Authority is Sweden's regulator of financial markets, including the insurance, credit, securities, and futures markets. Under the Swedish regulatory approach, all organized exchanges are subject to the same laws and regulations and may trade any financial product, provided they have the necessary rules to maintain a fair and orderly market. Also, all financial institutions are subject to the same laws and regulations and may sell any financial products to investors.

available. For example, the exchange officials said that options market makers[29] typically use the more liquid cash market to hedge their risk.

The Accord Prohibits Foreign Exchanges From Selling Single Stock Futures to U.S. Customers

Although foreign exchanges trade single stock futures, the accord prohibits the offer or sale of single stock futures based on either foreign or U.S. stocks to customers located in the United States. In addition to trading single stock futures on their domestic stocks, some foreign exchanges trade single stock futures on foreign stocks. For example, the OM Stockholm Exchange offers single stock futures on Swedish and Finnish stocks. However, foreign exchanges generally do not trade single stock futures on U.S. stocks.[30] According to CFTC officials, they are not aware of any laws that prohibit foreign exchanges from trading single stock futures on U.S. stocks. However, they noted that even if a foreign exchange did so, the accord would prohibit customers in the United States from purchasing them.[31] According to Securities Industry Association officials, it is unlikely that a foreign exchange could generate significant trading volume in futures on U.S. single stocks without U.S. customer participation in its market. As a result, these officials said that even if a foreign exchange were to trade futures on U.S. single stocks, such trading would not likely affect the stability of the U.S. stock market.

The OTC Market Offers Equity Swaps

The OTC derivatives market offers stock-based derivatives, including equity swaps on single stocks and narrow-based stock indexes.[32] These derivatives serve economic functions that are similar to those served by the stock-based futures that are prohibited under the accord. Both equity swaps and futures can be used to manage risk related to stock positions or to speculate on anticipated stock movements. However, equity swaps and futures are not perfect substitutes because of potential differences between their contract terms, transaction costs, and other factors. Also, retail customers are generally precluded from participating in the equity swaps market. In contrast, retail customers are allowed to participate in the exchange-traded futures market, but according to market observers,

[29] Market makers stand ready to buy or sell financial instruments, providing both a bid and offer price to the market.

[30] The OM Stockholm Exchange trades single stock futures on Pharmacia and Upjohn, which was formed through a November 1995 merger between Pharmacia (a Swedish company) and Upjohn (a U.S. company).

[31] In the United Kingdom, futures exchanges are allowed to trade single stock futures, but do not do so. However, betting houses legally offer “spread bets” on, among other things, U.S. single stocks. Spread bets are economically equivalent to off-exchange futures transactions, and U.S. customers are prohibited from entering into such transactions, according to a CFTC official.

[32] Other OTC derivatives that are economically similar to stock-based futures are OTC equity options and equity forwards.

they only account for an estimated 5 to 10 percent of the market. The Bank for International Settlements[33] has estimated that the equity swap market worldwide had a total notional value of $146 billion[34] as of year-end 1998—an increase of about 180 percent since March 1995. At year-end 1998, the equity swaps market accounted for a fraction of 1 percent of the notional value of the OTC derivatives market worldwide.

The Accord May Have Limited Investor Choice and Has Exposed Market Participants to Legal Uncertainty

The Shad-Johnson Jurisdictional Accord may have limited investor choice and has exposed market participants to legal uncertainty. Although investors can use stock-based options and equity swaps to hedge price risk, they cannot use stock-based futures to the same extent because of the accord trading prohibitions. Also, according to futures industry officials, the accord has limited the ability of U.S. investors to use foreign exchange-traded stock index futures to hedge the price risk associated with their foreign stock investments. Finally, counterparties to equity swaps have faced legal uncertainty because of the potential for such swaps to fall within the judicially crafted definition of a futures contract[35] and thus become subject to claims of illegality and unenforceability under the accord.

The Accord May Have Limited Available Hedging Instruments and Restricted Competition

The accord prohibitions may have limited investor choice by precluding U.S. exchanges from trading and investors from using futures on single stocks and certain stock indexes. Additionally, the accord prohibitions may have restricted U.S. futures exchanges from competing against other domestic and foreign markets trading stock-based derivatives.

The Accord May Have Limited the Range of Available Hedging Instruments

The accord trading prohibitions may have limited the range of stock-based derivatives that investors can use to hedge price risk associated with their stock investments. As previously discussed, investors can hedge price risk using options on single stocks and stock indexes, including narrow-based stock indexes. Also, a more limited range of investors can hedge such risk using equity swaps based on single stocks and stock indexes. However, investors cannot use futures on single stocks and certain stock indexes for such purposes because of the accord prohibitions. First, the accord prohibits the trading of futures on single stocks. Second, it allows futures

[33] The Bank for International Settlements was established in 1930 in Basle, Switzerland, by six Western European central banks and a U.S. financial institution. One of its functions is to provide a forum for cooperative efforts by central banks of major industrial countries.

[34] The Bank for International Settlements estimate includes equity forwards, which are different from equity swaps.

[35] The term “futures contract” is not defined by the CEA. Thus, the definition has evolved through judicial and agency interpretations.

exchanges to trade futures on stock indexes, provided that CFTC and SEC find that such contracts meet the accord's three standards.[36] CFTC and SEC have had few difficulties reaching agreement on whether a futures contract on a diversified, or broad-based, stock index meets the accord standards.[37] But they have had difficulties reaching agreement on whether a futures contract on a stock index representing a single industry meets these standards and, thus, may be traded. In light of their difficulties, SEC and CFTC issued joint guidelines in 1984 to use in making such determinations.

The Accord May Have Restricted Futures Exchanges From Competing Against Other Derivatives Markets

The accord trading prohibitions may have restricted the ability of the U.S. futures exchanges to compete against other markets trading stock-based derivatives. First, U.S. futures exchange officials have said that the accord prohibition on single stock futures has prevented them from competing against securities exchanges trading single stock options and foreign exchanges trading single stock futures. Second, futures exchange and FIA officials have said that the accord prohibition on certain stock indexes has placed the futures exchanges at a competitive disadvantage relative to the securities exchanges. According to these officials, SEC has allowed securities exchanges to trade options on a number of U.S. stock indexes that may not have been allowed to trade on futures exchanges. In 1994, SEC approved exchange rules to allow securities exchanges to trade options on a single industry stock index that is, among other things, composed of 10 or more stocks. In contrast, SEC and CFTC, under their joint guidelines (which are not a rule), have stated that a single industry stock index should, among other things, be composed of at least 25 stocks to be traded on a futures exchange. Although CFTC has approved U.S. futures exchanges to trade futures on single industry stock indexes,[38] the exchanges only recently have been allowed to trade futures on such indexes that are composed of fewer than 25 stocks. In comparison, SEC has approved securities exchanges to trade options on at least 35 single industry stock indexes composed of fewer than 25 stocks.

According to futures exchange officials, SEC's objection to a CBT application to trade futures on the Dow Jones transportation and utilities indexes illustrates how futures exchanges have been restricted from

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[36] As previously discussed, under the accord standards, a stock index futures contract must be (1) settled in cash; (2) not readily susceptible to manipulation; and (3) based on an index that either is a widely published measure of and reflects the market as a whole or a substantial segment of the market, or else is comparable to such a measure.

[37] As of January 12, 2000, CFTC had approved futures contracts on 47 diversified stock indexes.

[38] As of January 12, 2000, CFTC had approved futures contracts on 10 single industry stock indexes.

competing with securities exchanges. In September 1997, SEC approved CBOE to trade options on these two Dow Jones stock indexes—concluding that such approval would remove impediments to a free and open securities market by providing investors with an additional means to hedge market risk. In contrast, in July 1998, SEC exercised its authority under the accord and objected to the CBT application to trade futures on the same Dow Jones indexes. In objecting to the CBT application, SEC determined that the proposed futures failed to meet the accord's third standard, the substantial segment requirement. SEC noted, among other things, that the indexes had a small number of stocks (fewer than 25), raising concerns about the potential for the indexes to be used either to manipulate the market or as a substitute for single stocks.

In July 1998, CBT challenged SEC's decision in the U.S. Court of Appeals for the Seventh Circuit. In August 1999, the federal court vacated SEC's decision, concluding that it was not adequately supported, and left CFTC with the decision of whether to approve the proposed CBT futures contracts on the Dow Jones stock indexes.[39] In October 1999, CFTC approved the contracts. In November 1999, the Working Group reported that the court decision, along with the lack of an SEC objection to a recent sector index futures contract on the Internet stock price index, advanced the ability of the U.S. futures exchanges to offer a greater variety of stock index futures.[40]

The Accord May Have Restricted U.S. Investors From Hedging Foreign Stock Investments

According to FIA officials, the accord unnecessarily restricts the ability of U.S. investors to use foreign stock index futures that are traded on foreign exchanges to hedge their foreign stock investments in the most effective and efficient manner. Before a foreign exchange-traded stock index futures contract may be sold to U.S. investors, CFTC must first issue a no-action letter[41] to the foreign exchange for that contract.[42] According to FIA officials, the accord does not specifically require CFTC approval of foreign exchange-traded stock index futures. Instead, the officials said CFTC has

[39]See Board of Trade of the City of Chicago v. Securities and Exchange Commission, 189 F. 3d 713 (7th Cir. 1999).

[40] See Over-the-Counter Derivatives Markets and the Commodity Exchange Act, the President's Working Group on Financial Markets (November 1999).

[41] A no-action letter is issued by CFTC staff to indicate that they will not recommend enforcement action for violation of law or regulation if certain conditions are met. The letter does not reflect official Commission views.

[42] With the exception of securities-based futures and options, the CEA and CFTC regulations generally do not restrict the sale of foreign exchange-traded futures and options in the United States.

interpreted the legislative history of the accord as requiring its approval.[43] According to the legislative history, CFTC may certify a foreign securities index futures contract under such criteria as it deems appropriate.

CFTC officials said that they review foreign exchange-traded stock index futures to address concerns about manipulation and investor protection. For example, U.S. investors could be harmed if they bought a foreign exchange-traded stock index futures contract that was readily subject to manipulation. To facilitate the sale of such futures to U.S. investors, CFTC has initiated a procedure for issuing no-action letters for foreign stock index contracts that meet the accord requirements. As part of this procedure, CFTC has elected to consult with SEC. As of March 6, 2000, CFTC had issued no-action relief for 28 foreign stock index futures, and it had requests pending for 23 others.

According to FIA, the accord should be amended to facilitate foreign stock index futures transactions that are executed on a foreign exchange on behalf of U.S. investors. These officials said CFTC's no-action procedure for foreign stock index futures hinders the ability of U.S. futures commission merchants (FCM)[44] to meet the needs of their institutional investors, by preventing U.S. investors from trading many foreign stock index futures. Additionally, FIA officials said that no public policy purpose is served by preventing U.S. investors from trading certain foreign stock index futures, because U.S. investors are free to invest in foreign stocks. FIA officials said that the no-action procedure for foreign stock index futures is often lengthy, and that many stock-index products of foreign exchanges have not yet been granted no-action relief. The officials said that, as a result of the restriction, U.S. investors are often limited in their ability to hedge their foreign stock portfolios using the most efficient and effective foreign stock index futures. According to SEC and CFTC officials, some of the delays in issuing no-action letters have resulted from the length of time foreign exchanges have taken to respond to CFTC information requests.

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[43] According to FIA, CEA section 4(b) prohibits CFTC from adopting any rule or procedure that authorizes CFTC, in effect, to approve the terms or conditions of any futures contract traded on a foreign exchange, and the accord does not supersede or preempt section 4(b). CFTC disagrees with FIA. According to CFTC, while section 4(b) does not permit the Commission to regulate the terms and conditions of foreign futures, the legislative history of the section nevertheless makes clear that Congress expected the Commission to certify or otherwise review the offer or sale of foreign futures in the United States under such criteria as the Commission deems appropriate.

[44] FCMs are individuals, corporations, associations, partnerships, and trusts that solicit or accept orders to buy or sell futures and accept payment from or extend credit to those whose orders are accepted.

The Accord Has Been a Source of Legal Uncertainty for Equity Swaps

Under the Futures Trading Practices Act of 1992, Congress provided CFTC with the authority to enhance legal certainty for swaps by exempting any contract from all CEA provisions, except those of the accord—section 2(a)(1)(B). Until this time, all swaps—including equity swaps—faced the possibility of falling within the judicially crafted definition of a futures contract, because of their similarities to exchange-traded futures. If found to be futures, swaps could have been deemed illegal and unenforceable, because they would not have been traded on an exchange as required by the CEA. Before CFTC was granted its exemptive authority, it issued a swaps policy statement in 1989 to reduce the legal risk faced by swaps by clarifying the conditions under which it would not regulate swaps as futures. However, the policy statement did not eliminate all legal risk, because it left open the possibility that a swaps counterparty might try to have a court invalidate a swap as an illegal, off-exchange futures contract.

In January 1993, CFTC used its exemptive authority under the 1992 act to exempt a broad group of swaps from the CEA's exchange-trading and other requirements, thereby reducing or eliminating the legal risk that such swaps could be unenforceable. However, because CFTC could not exempt swaps from the accord, equity swaps have continued to face legal risk. According to market observers, if equity swaps were found to be futures, they would be in violation of the accord—making them illegal and unenforceable.[45] First, equity swaps on individual stocks that were deemed to be futures would violate the accord prohibition on single stock futures. Second, equity swaps on stock indexes that were deemed to be futures would violate the CEA requirement that stock index futures be traded on an exchange. According to CFTC, swaps counterparties can still rely on its swaps policy statement, and according to International Swaps and Derivatives Association officials, equity swaps counterparties routinely do so.

In its November 1999 report, the Working Group noted that CFTC cannot grant exemptions from the restrictions of the Shad-Johnson Accord and, therefore, recommended that swaps—including equity swaps—meeting certain conditions be specifically excluded from the CEA.[46] In support of

[45] As with equity swaps, hybrid instruments that reference nonexempt securities face legal uncertainty, because a court could find them to be subject to the accord prohibition on single stock futures. Hybrid instruments possess, in varying combinations, characteristics of futures, options, securities, and/or bank deposits. To enhance the legal certainty of hybrids that reference nonexempt securities, the Working Group recommended that a provision be enacted in the CEA to clarify that the accord shall not be construed to apply to hybrid instruments that have been exempted from the CEA.

[46] The Working Group recommended that bilateral swaps entered into by eligible swaps participants, on a principal-to-principal basis, should be excluded from the CEA, provided that the transactions are not conducted on a multilateral transaction execution facility in which bids and offers are open to all

its recommendation, the Working Group reported that swaps involve sophisticated counterparties, who do not require the same protections under the CEA as those required by retail customers. It also reported that swaps generally are not susceptible to manipulation and do not serve a price discovery[47] function. Likewise, U.S. securities exchanges have supported excluding equity swaps from the CEA to resolve legal uncertainty. However, the New York Stock Exchange stated that equity swaps should be subject to SEC jurisdiction to ensure that such swaps will not be used for regulatory arbitrage or to circumvent the insider trading, fraud, and manipulation prohibitions of the securities laws. The exchange further stated that regulating equity swaps as securities would promote regulatory parity between such products and single stock futures, which it stated should also be regulated as securities. U.S. futures exchanges have also supported providing legal certainty to swaps under the CEA. However, they stated that regulatory parity between the exchange-traded futures and OTC derivatives markets first needs to be achieved so that the exchange-traded market can compete with the OTC market on a level playing field. For example, CME testified in February 2000 that if equity swaps are allowed to trade in the OTC market outside of the CEA, single stock futures should be allowed to trade on U.S. futures exchanges.

Concerns Exist About Repealing the Accord Prohibitions

SEC and U.S. securities exchange officials have expressed concerns about repealing the accord trading prohibitions without first resolving the differences between the securities and commodities laws and regulations. They are concerned that, as a result of the differences, the prohibited futures could be used as substitutes for single stocks to circumvent compliance with federal securities laws and regulations. The most significant legal and regulatory differences that they identified include the lack of comparable insider trading prohibitions, margin levels, and customer protection requirements. In its November 1999 report, the Working Group cited these as well as other legal and regulatory differences that will need to be resolved if the accord prohibitions are repealed. Also, several members of Congress identified concerns for SEC to address before submitting to Congress any legislative proposals related to the accord.

participants. The Working Group recommended that certain types of electronic trading systems be excluded from the CEA, even if bids and offers are open to all participants, provided that the participants are acting for their own account.

[47] Price discovery is the process of determining price on the basis of supply and demand factors.

The CEA Does Not Prohibit Insider Trading

According to SEC and the U.S. securities exchanges, the CEA's lack of insider trading prohibitions comparable to those included in the securities laws would pose significant risk to the integrity of the stock market if the accord prohibitions were repealed. In contrast to the CEA, the federal securities laws broadly prohibit insider trading—that is, the trading of securities on the basis of material nonpublic information about a corporate issuer.[48] According to SEC officials, unless single stock futures are deemed securities, the securities law insider trading prohibitions and the extensive body of case law interpreting those prohibitions would not apply. SEC officials stated that simply grafting insider trading prohibitions on the CEA would not solve the problem. They said that the prohibited futures must be considered securities to be subject to the insider trading prohibitions developed over the years by SEC and the courts.

SEC and securities exchange officials have expressed concern that if single stock futures were allowed to trade without being subject to insider trading prohibitions, they could be used to circumvent federal securities laws and to profit legally in the futures market based on inside information. For example, a person with positive material nonpublic information about a stock issuer could buy a futures contract on the stock. When the information was disclosed to the market, the value of the stock and, in turn, the futures contract could rise. Because the CEA does not prohibit futures trading based on material nonpublic information, the trader would not be in violation of the CEA, and any resulting profit from the futures contract would not be illegal. In contrast, if the profit were obtained through the purchase of stock or an options contract, it would be a violation of the federal securities laws.

According to SEC officials, because the accord has allowed CFTC to approve only futures on stock indexes that reflect a substantial market segment, the potential that an individual might profit from inside information when trading futures on the approved stock indexes has been minimized. As a result, the absence of insider trading prohibitions in the futures market has not been an issue for the currently traded stock index futures.

CFTC and U.S. futures exchanges agree that the lack of insider trading prohibitions under the CEA that are comparable to those included in the securities laws would need to be addressed if the accord prohibitions are repealed. In addition, futures exchange officials said that they could use

[48] According to CFTC officials, under limited circumstances, insider trading involving the futures market might be covered under the CEA antifraud provisions.

their existing reporting and surveillance systems, with modifications, to help deter and detect insider trading involving stock-based futures. For example, CFTC has large trader reporting requirements and systems that enable CFTC and the futures exchanges to track traders holding large futures positions. Futures exchange officials said that these reports and systems, which are absent in the securities markets, allow CFTC and the exchanges to detect unusual trading activity in stock index futures. New York Stock Exchange officials told us that the securities exchanges have spent years and millions of dollars developing systems to deter and detect insider trading, and that the futures exchanges could not readily match the capabilities of these systems.

Margins on Stock, Security Options, and Futures Differ

Margins for stock, stock-based options, and futures differ in terms of their purpose, source, and computation. According to SEC and the U.S. securities exchanges, should the accord trading prohibitions be lifted, lower margins on single stock futures compared to stocks would allow investors to make greater use of leverage, thereby increasing the risk of customer loss, market manipulation, and systemic risk. CFTC, the Federal Reserve, and the U.S. futures exchanges disagree with SEC and U.S. securities exchanges about the potential effect of margin differences. However, to alleviate concerns, the futures exchanges have said that they would be willing to set margins on single stock futures at a level comparable to margins on single stock options.

Margins Differ in Terms of Purpose, Source, and Computation

Traditionally, stock margin has been used to control the allocation of credit, reduce the risk of price instability, and protect investors from becoming overly leveraged. For stocks, margin is the minimum down payment that a customer must pay to a broker to fund a stock purchase. The remainder of the purchase price can be borrowed from the broker, with the broker then retaining the stock as collateral on the loan. Brokers do not typically require customers to pay the margin until 5 days after the trade,[49] during which time the broker is exposed to the risk that the customer will not make payment. Under Regulation T, the Federal Reserve set minimum margin for purchasing stock in 1974 at 50 percent of the current market price of a stock, limiting the amount of credit a broker may extend to a customer to 50 percent of the stock purchase price. This requirement is a minimum; securities brokers may set a higher requirement. Additional margin payments would be required to maintain a margined stock position if the stock's market price, and thus the value of

[49] Under Regulation T, the customer payment period is the number of days in the standard security settlement cycle, which is set by SEC and is 3 business days from the date of the contract, plus 2 business days.

the collateral, significantly declined before the loan was repaid.[50] The Federal Reserve allows securities exchanges to set additional margin requirements for maintaining a margined stock position, subject to SEC approval.

For securities-based options, margin is a performance bond and, unlike stock margin, does not typically involve an extension of credit. In contrast to stock margins, the primary purpose of options margin is to protect the financial integrity of the firm and the market, not customers. Options margin is paid only by the option seller,[51] to ensure contract performance should the option be exercised.[52] The Federal Reserve is authorized to set margins for options but has incorporated by reference in Regulation T the margin rules of the options exchanges, subject to SEC approval. Margin for stock option sellers (puts and calls) is currently set by exchange rules at the current market value of the option (the premium) plus 20 percent of the current market value of the underlying stock (i.e., 100 shares per option contract), minus the amount (if any) that the option is out-of-the-money.[53] These requirements are minimums; securities brokers may set higher requirements. Additional margin payments would be required if the market value of the stock option changed and the customer's margin account balance fell below minimum requirements before the option exercise date.[54] Because the computation of options margin varies depending on several factors, including the exercise price and expiration date, comparing options and futures margins is difficult.[55]

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[50] According to New York Stock Exchange and National Association of Securities Dealers rules, margin accounts must contain at least 25 percent of the current market value of all purchased securities in a customer's account.

[51] The option buyer pays only a nonrefundable premium—an amount that is determined by the market.

[52] To exercise an option is to invoke the right granted to the owner of an option contract. In the case of a call, the option owner buys the underlying stock. In the case of a put, the option owner sells the underlying stock.

[53] An option is out-of-the-money when its exercise price is above (call) or below (put) the current market price.

[54] According to a National Association of Securities Dealers rule, margin for the option seller cannot be less than the current market value of the option plus 10 percent of either the current market value (call) or the option's aggregate exercise price (put).

[55] CBOE is currently attempting to develop a pilot program that would implement risk-based margining for portfolios of broad-based index options traded by institutional or high net-worth/sophisticated investors. The pilot program would require SEC approval; however, CBOE has not yet submitted the program to SEC for review. CBOE anticipates that, under the pilot program, margin requirements for eligible portfolios of index options generally will be lowered to better reflect the risk associated with such portfolios. The futures exchanges currently use a risk-based portfolio margining system.

For futures, margin is also a performance bond and does not involve the extension of credit. Also, the purpose of futures margin is to protect the financial integrity of firms and the market, not customers. Futures margin is paid by both the buyer and seller of a futures contract when the position is established, to ensure that they can fulfill their contractual obligations. The Federal Reserve is authorized to set margin levels for stock index futures but has delegated the authority to CFTC. Subject to CFTC oversight, futures exchanges set margin for stock index futures. Margin levels are set using a portfolio margining system based on the historical price volatility of the underlying, current and anticipated market conditions, and other factors. They are typically set to cover at least 95 percent of historical 1-day price moves for the contract's underlying commodity or index. For example, as of February 9, 2000, the margin on CME's E-Mini Standard & Poor's 500 index futures contract was about $4,700, approximately 6.6 percent of the value of the futures contract. These requirements are minimums; futures brokers may set higher requirements. In futures margining, payments are made at least daily from the margin accounts of those futures contracts decreasing in value to those increasing in value, to reflect net gains or losses. This process, called marking-to-market, ensures that losses on futures positions do not accumulate over more than one day. Additional margin is collected, if a margin account balance falls below minimum requirements, to bring the account back to its original balance.

Concerns Exist About Leverage and Customer Losses

SEC and securities exchange officials have stated that highly leveraged customers in single stock futures could experience significant losses during volatile markets. These customers would be required to make significant daily margin payments to cover their losses. According to Federal Reserve officials, margins can be used to limit the amount of customer leverage, but more effective tools exist to protect customers, such as disclosure and suitability requirements (discussed below). In addition, they said daily futures margin calls due to adverse price changes can serve to limit customer losses by prompting customers to liquidate losing positions before more significant losses can accumulate.

Concerns Exist About Manipulation

The U.S. Securities Markets Coalition has stated that the high degree of leverage that might be available in connection with single stock futures could also increase the potential for manipulation of stock prices. Specifically, the potential for greater profit from a highly leveraged futures position because of even a small price movement in the underlying stock could encourage attempts to manipulate stock prices. That is, investors may acquire a large futures position in a single stock and then attempt to artificially drive up the price of the stock by buying the stock or through other means. However, SEC said that such manipulation could be attempted with less economic risk using single stock options.[56]

According to CFTC officials, SEC and CFTC have agreements to share surveillance information, and these agreements have been effective in detecting intermarket abuses involving stock index futures and stocks. In addition, securities and futures exchanges have also entered into agreements to share surveillance and investigative information on a bilateral basis and through the Intermarket Surveillance Group.[57] The goal of these agreements is to coordinate the sharing of such information involving securities, options, and futures to deter and detect intermarket trading abuses, such as manipulation. For example, CBT officials said that CBT and the New York Stock Exchange share trading data under a bilateral information-sharing agreement to assist in detecting manipulation involving stocks and futures. The officials said that the agreement could be expanded to cover additional stocks, should single stock futures be allowed to trade. In addition, CFTC and futures exchange officials said that their large trader reporting systems allow them to identify market participants who are overexposed to the market, a capability SEC and the securities exchanges lack.

Concerns Exist About Systemic Risk

The U.S. Securities Markets Coalition has stated that, during periods of extreme market volatility, the overuse of leverage could significantly impair the integrity of the stock market, creating systemic risk. According to Federal Reserve and CFTC officials, the futures exchanges have a record of setting margins at levels that have protected the financial integrity of the market, and thereby have limited systemic risk. Moreover, the Federal Reserve has noted that margins are but one component of sophisticated risk control systems that include frequent marking-to-market of customer positions, market surveillance, and active risk management. Consistent with this view, the Working Group concluded in its 1988 study of the 1987 market decline that the then existing margins for stocks, stock index futures, and options provided an adequate level of protection to the financial system.[58] The Working Group also concluded that “harmonious” margins for stocks and futures do not imply that margins must be equal. It noted that margin adequacy depends on the volatility of prices and the

[56] As previously discussed, because an option buyer has the right but not the obligation to buy or sell the underlying, an option buyer's risk is limited.

[57] The Intermarket Surveillance Group membership is composed of U.S. securities and options exchanges, with futures exchanges participating as affiliate members.

[58] The SEC Chairman disagreed with the other Working Group members and said that margins on futures and options should be increased.

length of the grace period following a margin call. Finally, a 1996 Federal Reserve study found that the margining systems used by securities and futures exchanges for Standard & Poor's 500 index options and futures, respectively, differ in their approach but provide substantially the same market risk protections. The study also found that the portfolio-based margining system used by the futures exchanges is more efficient than the strategy-based margining system used by securities exchanges, because it achieves the same result but with a lower level of collateral (i.e., margin).

Futures Margins Are Risk-Based, but Exchanges Are Willing to Match Option Margins to Address Concerns

The futures market margining system sets margin levels based on risk. As a result, margins set for single stock futures would be expected to be higher than those currently required for traditionally less volatile and, therefore, less risky stock index futures. For example, using the same margining system as U.S. futures exchanges, the OM Stockholm Exchange has set margins for single stock futures at 7.5 to 25 percent of the value of the futures contract, based on the volatility of the underlying stock. These levels are higher than the amount set by the CME for the E-Mini Standard & Poor's 500 stock index futures contract. Margin levels for some futures on single U.S. stocks could be in the same range as those set for single stock options by U.S. securities exchanges. To address SEC and securities exchange concerns about margins, futures exchange officials have said that they would be willing to set margins on single stock futures at a level comparable to the margins securities exchanges have set for single stock options.

Customer Protection Requirements for Securities and Futures Differ in Approach

The securities and futures markets approach to customer protection differs. SEC and securities exchange officials are concerned that the lack of a futures market suitability rule would expose customers to risk, if the accord prohibitions on futures on single stocks and certain stock indexes are repealed. According to NFA, although the futures industry does not have a suitability rule, customer protection regulations do not differ significantly between the securities and futures markets, and the basic type of protection afforded by each market is the same.

SEC and U.S. Securities Exchanges Are Concerned About the Futures Market's Lack of a Suitability Rule

SEC and U.S. securities exchanges have expressed concern that without the benefit of a suitability rule, single stock and certain stock index futures would be marketed to unsophisticated and unsuitable retail customers as cheap substitutes for stocks and stock options. Securities self-regulatory organizations have imposed suitability requirements on exchange members and other registered brokers. Under these requirements, brokers that make recommendations to their customers may only recommend those securities (including options) that they believe are suitable in light of the financial position and investment goals of the customers. According to the New York Stock Exchange, these requirements apply whenever recommendations are made, not just when an account is opened. However, these requirements do not apply when brokers do not make recommendations to customers, such as may occur when trades are made either through discount brokers or directly online. Brokers are also required to provide additional written risk disclosures to options customers, but only when they initially open an account.

According to SEC and U.S. securities exchanges, without a suitability rule, FCMs could recommend single stock futures to retail customers without determining whether the recommendation is suitable for them. SEC and U.S. securities exchanges are concerned that retail customers buying or selling stock-based futures would be exposed to the risk of unlimited loss associated with an adverse price change in a futures contract. In contrast, the risk of loss to options buyers (but not to sellers) is limited to the price of the option premium. Also, as discussed previously, SEC and U.S. securities exchanges are concerned that retail customers would be exposed to the risk of loss associated with high leverage. Industry representatives have expressed additional concern that a large number of retail customer losses in the futures market could undermine investor confidence in all financial markets, including the stock market.

Swedish regulatory officials told us that they have not had any cases of customer abuse involving single stock futures. They noted, however, that the lack of any such cases might be due to the limited number of retail customers who use such products. According to Swedish exchange officials, few brokers market single stock futures to retail customers, in part because futures pose greater risks than do stocks. According to CME officials, if single stock futures were allowed to trade, the exchange would be interested in marketing them to retail customers.

NFA Officials Said That Futures and Securities Rules Afford the Same Protections

According to NFA officials, customer protection regulations do not differ significantly between the securities and futures markets. NFA officials said that the basic type of protection afforded by each is the same. According to CFTC officials, sales practice requirements under the CEA focus on providing a full disclosure of the risks associated with futures trading. Accordingly, CFTC and NFA require FCMs to provide customers with written risk disclosure statements when they open an account. This and other sales practice requirements are predicated on the belief that all futures trading is highly risky, irrespective of the type of underlying. In contrast to futures, individual securities possess varying degrees of risk. As a result, according to NFA, the suitability of particular products for an individual customer varies with the customer's ability to assume the risk associated with the products.

According to NFA, because all futures involve a high degree of risk, little or no basis exists for assuming that one type of futures contract would be suitable for a particular customer, while another type would be unsuitable for the same customer. For this reason, according to NFA, CFTC decided against adopting a suitability rule that had been proposed for the futures industry in 1978. NFA stated that the more appropriate focus is on whether the customer should be trading futures at all. To that end, NFA has adopted a "know your customer rule" that requires its members to obtain the same type of information about their customers as is required by the securities suitability requirements. However, according to SEC and securities exchange officials, this obligation exists only when an account is initially opened, and the futures rule does not require a continuous assessment of suitability, as does the securities rule.

According to NFA, if a firm determines that a customer should not be trading futures, the firm is obligated to so inform the customer. However, if a customer decides to ignore this information, the firm can elect to complete the customer's transactions after documenting that the firm alerted the customer to its determination. A CFTC official said that FCMs are financially liable if a customer defaults and, thus, have an incentive to ensure that a customer is not overextended.

Other Concerns Exist About the Differences Between the Securities and Commodities Laws

In addition to the three issues discussed previously, SEC, the U.S. securities exchanges, the Working Group, and several members of Congress have identified other provisions of securities and commodities laws that will need to be reviewed to determine how they should apply to single stock futures, if at all, should the accord trading prohibitions be repealed. These provisions include various requirements or restrictions to combat fraud and market manipulation or to facilitate market transparency and disclosure.

According to SEC and securities exchange officials, additional provisions of the securities laws that are of concern include (1) restrictions on short-term profits by large shareholders or corporate insiders on the purchase or sale of corporate stock, (2) limitations on stock repurchases by issuers, (3) restrictions on stock purchases during stock distributions, and (4) requirements to notify SEC when acquiring a large block of stock. These officials said that the remainder of the securities and commodities laws and regulations would also need to be reviewed to determine how they should apply to single stock futures, if at all, should the accord trading prohibitions be repealed.

In its November 1999 report, the Working Group concluded that the accord trading prohibition on single stock futures "can be repealed if issues about the integrity of the underlying securities market and regulatory arbitrage are resolved." According to the Working Group, from the perspective of the securities laws, the issues raised by the trading of single stock futures include margin levels, insider trading, sales practices, real-time trade reporting, activities of floor brokers, and CFTC's exclusive jurisdiction over futures. The Working Group also stated that from the perspective of the commodities laws, the issues raised by such products include clearing, segregation, large trader reporting, and direct surveillance.[59] The Working Group recommended that SEC and CFTC work together and with Congress to determine whether single stock futures should be permitted to trade and, if so, under what conditions.

In a February 9, 2000, letter, Representatives Dingell, Markey, and Towns asked SEC to respond to a list of questions concerning the potential impact of repealing the accord prohibitions on the U.S. securities market. Their request reflected concerns about the conditional nature of the Working Group's recommendation and the complexities involved in resolving the issues raised by single stock futures. Their letter explained that they were not certain that the issues identified by the Working Group could be resolved in a manner consistent with the public interest, the protection of investors, and the maintenance of fair and orderly markets, especially if done in haste and within the confines of a regulatory structure that bifurcates regulation over certain financial derivatives between SEC and CFTC. In addition, they asked SEC to satisfactorily address their questions before submitting any legislative proposals related to the accord to Congress.

Resolving the Jurisdictional Question Is Key to Addressing Concerns

Pivotal to addressing the legal and regulatory concerns related to repealing the current trading prohibitions is resolving the jurisdictional question of whether SEC, CFTC, or both agencies should regulate single stock and certain stock index futures. The answer to this question would determine whether such futures are regulated under the securities and/or commodities laws. In turn, the answer would affect the types of legal and regulatory changes that would be needed. According to securities exchange officials, futures on single stocks and certain stock indexes

[59] The Department of the Treasury noted that questions as to the appropriate tax treatment of single stock futures would also need to be addressed.

could be allowed to trade, if such futures were regulated as securities. According to futures exchange officials, if the prohibited futures were allowed to trade, CFTC could effectively regulate them under the CEA. In response to congressional requests, SEC and CFTC have tentatively agreed on an approach to allow single stock futures to be traded on both U.S. securities and futures exchanges. Regardless of whether SEC, CFTC, or both agencies regulate such futures, some of the regulatory concerns could be addressed by trading them electronically and/or under a pilot program.

SEC Could Be the Primary Regulator of the Prohibited Futures

According to SEC and securities exchange officials, futures on single stocks and certain stock indexes could be allowed to trade, if such futures were regulated as securities. For example, under this approach, single stock and certain stock index futures would be made subject to the insider trading prohibitions of the federal securities laws and covered by the margin and sales practice requirements of the securities exchanges. These officials also said that such an approach would enable SEC to ensure that stocks, stock-based options, and stock-based futures were consistently regulated under the federal securities laws. According to SEC officials, the prohibitions on single stock and certain stock index futures were not based on any economic differences between options and futures. Rather, SEC officials said the prohibitions were based on regulatory differences that could allow such futures, unlike single stock options, to be used as stock substitutes to circumvent securities laws and regulations. Similarly, the securities exchange officials said that they do not question the potential economic utility of single stock futures.

According to CFTC officials, the regulatory scheme created by the accord is consistent with the overall approach embraced by Congress to separate securities and futures regulations. CFTC officials said that providing SEC with jurisdiction over both stocks and stock-based futures could undermine this approach and fragment the regulatory environment by having futures regulation turn on the underlying commodity rather than the economic function served by the product. The former CFTC chairman responsible for negotiating the accord stated that the accord sought to avoid regulation of futures based on the underlying commodity, because such an approach could create a fragmented regulatory environment. This approach was consistent with the decision by Congress in 1974 to replace the Department of Agriculture with CFTC as the futures market regulator. NFA officials have also questioned the need for SEC to regulate futures based on stocks when CFTC does not regulate the underlying commodity of any traded futures contract. According to securities exchange officials, stocks are different from other commodities underlying futures contracts. These officials said that SEC regulates stocks under a comprehensive body of securities law that should not be undermined. Also, they said that, unlike other derivatives in which the underlying has a poorly developed cash market and the derivative serves a price discovery function, the cash market for stock-based futures is well developed and serves a price discovery function.

CFTC Could Be the Primary Regulator of the Prohibited Futures

According to futures exchange officials, if the prohibited futures are allowed to trade, CFTC could effectively regulate them under the CEA. These officials said that the CEA could be amended and other steps could be taken to address the legal and regulatory concerns involving the prohibited futures. For example, as a means of addressing SEC concerns about insider trading, CBT and CME have proposed providing SEC with the authority to enforce insider trading prohibitions for stock-based futures to the same extent that it does for stock-based options. Similarly, CFTC officials said that they would support amending the CEA if the accord prohibitions were lifted, so that CFTC could share its exclusive jurisdiction over single stock futures with SEC in regulatory matters, such as setting margins and market surveillance.

CFTC officials said that their experience with the currently traded stock index futures has shown that the division of securities (including stock-based options) and futures regulation between SEC and CFTC has worked well. These officials said that each has effectively regulated its respective market. According to the CFTC officials, to the extent that intermarket problems have arisen, SEC and CFTC have been able to develop mechanisms to address them. For example, the officials said that the securities and futures exchanges, at the recommendation of the Working Group,[60] established circuit breakers[61] to address market emergencies involving stocks and stock index futures. As previously discussed, futures exchange officials said that they could use their reporting and surveillance systems, with modification, to help deter and detect insider trading and manipulation involving the prohibited futures.

Securities exchange officials said that dividing regulation of stocks and the prohibited futures between SEC and CFTC would be less effective and efficient than having SEC regulate both products. These officials said that using a single regulator instead of two regulators would eliminate the need to coordinate securities and futures market oversight. Furthermore, securities officials said that dividing regulation between SEC and CFTC

[60] See Interim Report of the Working Group on Financial Markets (May 1988).

[61] Circuit breakers are a coordinated system of trading halts and price limits on stock and derivatives markets that are designed to provide a cooling-off period during large, intraday market declines.

could create opportunities for regulatory arbitrage. These officials said that investors could decide to use single stock futures, instead of stocks or stock options, based on regulatory reasons rather than on the economic merits of the competing products. For example, securities exchange officials have expressed concern that margins for the prohibited futures would be lower than margins for stocks and stock-based options. As a result, these officials said that the prohibited futures would have a competitive advantage in terms of transaction costs.[62] As previously discussed, futures exchange officials said that they would address this concern by setting margins for single stock futures at a comparable level to margins for options on single stocks.

SEC and CFTC Could Share Jurisdiction Over the Prohibited Futures

In light of the Working Group's conclusions and recommendation, several members of Congress asked SEC and CFTC to study various issues related to the accord. In December 1999, Senators Gramm and Lugar asked SEC and CFTC to study the desirability of lifting the accord trading prohibition on single stock futures. They also asked the agencies to provide any legislative proposals for taking such action to Congress no later than February 21, 2000, a date that was subsequently extended to March 2, 2000. Likewise, in January 2000, Representatives Bliley, Combest, Ewing, and Stenholm made a similar request to the agencies.

Responding to the congressional requests, on March 2, 2000, SEC and CFTC presented a tentative approach for allowing single stock futures to be traded on both U.S. securities and futures exchanges. Although SEC and CFTC had not yet developed a legislative proposal for repealing the accord prohibition, they agreed that any such legislation should allow both agencies, acting as equal principals, to consistently regulate single stock futures, the intermediaries that offer them, and the markets that trade them. Accordingly, the agencies noted that any legislation in this area should empower SEC and CFTC to cooperate and coordinate their respective regulations to the extent practicable. They also noted the importance of avoiding the imposition of unnecessarily burdensome or duplicative regulation on the securities and futures markets as well as their participants. According to SEC and CFTC officials, one of their major challenges is developing a process to ensure that regulation of the securities and futures markets as well as intermediaries remains consistent and appropriate as the markets evolve. These officials said that the

[62] Recognizing that futures, options, and stocks could be used as substitutes in some cases, Federal Reserve officials said that margin cost is just one of the factors that market participants consider in making an investment decision. However, the officials said that the significance of this cost is unclear.

agencies plan to continue working together with the goal of providing a comprehensive legislative proposal to Congress before it adjourns.

SEC and CFTC have tentatively agreed on the initial standards for trading single stock futures, such as harmonizing margin requirements, restricting dual trading,[63] testing sales and supervisory personnel, and establishing uniform listing standards. They have also agreed that SEC would take the lead in detecting, deterring, and prosecuting insider trading involving single stock futures. Additionally, the agencies would seek to avoid duplicative oversight in areas where their regulations are equivalent.

SEC and CFTC have explored using a "notice registration" process to avoid duplicative regulation of their registered intermediaries (e.g., broker-dealers and FCMs) and registered markets. Under this process, entities registered with one regulator would be required only to file a form to alert the other regulator of their single stock futures activities. As such, registered intermediaries and markets would not be required to go through a duplicative registration process. Nonetheless, such entities would be subject to "core provisions" of the federal securities and commodities laws. SEC and CFTC have not yet agreed on the scope or application of the core provision. They have identified and discussed a variety of issues relating to the trading of single stock futures that may need to be addressed in their regulatory proposal, including customer suitability and disclosure as well as large trader reporting.

Although unresolved issues remain, the agencies have agreed to develop a memorandum of understanding to implement the regulatory framework. The memorandum would provide a regulatory blueprint that would allow single stock futures to be traded on securities and futures exchanges and by intermediaries currently regulated by only one agency, without undermining investor protection and market integrity, imposing duplicative regulation, and promoting regulatory arbitrage. In addition, the agencies agreed to develop a coordinating committee to address ongoing issues regarding their shared regulation of markets and intermediaries trading single stock futures.

[63] Dual trading occurs when (1) a floor broker executes customer orders and, on the same day, trades for his or her own account or an account in which he or she has an interest, or (2) an intermediary carries customers accounts and also trades, or permits its employees to trade, on the same trading day, in accounts in which it has a proprietary interest.

Some of the Regulatory Concerns Could Be Addressed by Trading the Prohibited Futures Electronically and/or Under a Pilot Program

Some of the regulatory concerns surrounding the prohibited futures could be addressed by trading such futures electronically[64] and/or under a pilot program. For example, CFTC officials and others have said that electronic trading systems can provide unalterable audit trails that record precisely when, where, and by whom an order was placed. They said that such information could be used to deter and detect market abuses, including manipulation, and customer abuses, such as frontrunning.[65] Similarly, electronic trading systems could enhance customer protections by improving the ability of FCMs to monitor and control customer activities. According to securities exchange officials, trading single stock futures electronically would not address many other concerns, including concerns about insider trading, margins, and sales practices. Futures exchange officials told us that they would likely trade these futures through electronic trading systems, but would also like the flexibility to trade them through open outcry.[66]

According to a market observer specializing in the securities laws, a pilot program could be used to allow trading of the prohibited futures on a trial basis. CFTC used such an approach to reintroduce the trading of options on futures. Using a pilot program to introduce trading in the prohibited futures could provide regulators with a way to test the adequacy of responses to specific regulatory concerns. Also, to address concerns about sales practices and retail customer losses, regulators could restrict access to the pilot program to sophisticated market participants, such as those defined as “eligible swap participants” in CFTC regulations.[67] Similarly, the market observer suggested that a pilot program could be used to test the trading of stock index futures not currently allowed under the accord. He said that this approach might be an effective and efficient way to test the market for these products, while minimizing the potential for insider trading and manipulation. He said that such stock index futures would probably appeal only to institutions and other market professionals, avoiding existing concerns that single stock futures would be marketed to unsuitable retail investors. However, one drawback of a pilot program is

[64] We are currently reviewing the use of electronic trading systems for exchange-traded and OTC derivatives and will report our findings separately.

[65] Frontrunning is taking a futures or options position based on nonpublic information regarding an impending transaction by another person in the same or a related futures or options contract.

[66] Open outcry is a method of public auction under which futures are traded by floor participants who verbally or through hand signals make bids and offers to each other at centralized exchange locations.

[67] Eligible swap participants include banks, securities firms, insurance companies, commercial firms with a net worth exceeding $1 million, and individuals with total assets exceeding $10 million. 17 C.F.R. § 35.1(b)(2)(1999).

that its potentially temporary status may deter participation. According to securities exchange officials, another drawback is that SEC and CFTC would first need to resolve most of the jurisdictional and regulatory issues before single stock and certain stock index futures could be traded under a pilot program. As a result, the officials said such an approach would not be likely to expedite trading of the prohibited futures.

Conclusions

Repealing the accord trading prohibitions on single stock and certain stock-based index futures raises challenging legal and regulatory issues because of (1) the potential to use the prohibited futures as stock substitutes and (2) differences between securities and commodities laws and regulations. SEC, CFTC, and others have identified approaches for addressing such issues, with each approach pivoting on the jurisdictional question of whether SEC, CFTC, or both should regulate single stock and certain stock index futures. These approaches indicate that the legal and regulatory issues are resolvable. To that end, SEC and CFTC have begun working together to address these issues. However, uncertainty remains about the outcome of such efforts. Differences in SEC and CFTC perspectives, as well as in the securities and commodities laws, could continue to impede efforts aimed at reaching the compromises necessary to repeal the accord prohibitions.

The existence of active securities option and OTC equity derivatives markets, coupled with a very small but growing foreign market in single stock futures, indicates that the prohibited futures might serve a useful economic purpose. At the same time, the experience of these markets indicates that demand for the prohibited futures might be limited. Nonetheless, repealing the trading prohibitions could enhance the ability of the U.S. financial markets to compete and to develop innovative contracts. First, such action would allow U.S. exchanges to introduce additional stock-based futures and, in turn, let the marketplace determine their economic utility. Second, such action could allow U.S. futures exchanges to compete against other derivatives markets. Third, by eliminating the accord prohibition on certain stock index futures, U.S. firms could offer customers in the United States foreign stock index futures that could be used to hedge foreign stock investments. Fourth, the legal certainty of equity swaps could be addressed, thereby facilitating the growth of this market. We recognize, however, that the legal certainty for equity swaps could also be addressed separately by excluding such products from the CEA, as recommended by the Working Group.

Congressional interest has been instrumental in bringing SEC and CFTC together to discuss the legal and regulatory issues involved in repealing the accord trading prohibitions. Recognizing that the resolution of the legal and regulatory issues pivots on the jurisdictional question of which agency or agencies should regulate single stock and certain stock index futures, continued congressional attention may be a key factor in the ultimate resolution of issues related to the repeal of the accord prohibitions.

Recommendations

Given the potential benefits of repealing the accord trading prohibitions and the potential for jurisdictional differences to continue to impede such efforts, we recommend that the Chairmen of SEC and CFTC (1) work together and with Congress to develop and implement an appropriate legal and regulatory framework for allowing the trading of futures on single stocks and all stock indexes, and (2) submit to Congress legislative proposals for repealing the accord trading prohibitions.

Agency and Industry Comments and Our Evaluation

Overall, the federal financial regulators and the securities and futures industry commentators generally agreed with, or did not comment on, our conclusions and recommendations. However, SEC, the New York Stock Exchange, the Securities Industry Association, and the Securities Markets Coalition commented that our draft report did not address all of the concerns and issues associated with trading single stock futures. They said that the report, in some instances, oversimplified the complex solutions required to bridge the disparities that exist between securities and futures regulation. We agree that repealing the accord trading prohibitions involves more than resolving the three regulatory and legal differences that we discuss in our report—that is, the lack of comparable insider trading prohibitions, margin levels, and customer protection requirements. We expanded our discussion of the differences between the securities and commodities laws and regulations to clarify that other differences exist that would need to be addressed if the accord prohibitions were lifted.

Technical comments provided by CFTC, SEC, the Federal Reserve Board, Treasury, CBT, FIA, the New York Stock Exchange, the Securities Industry Association, and the Securities Markets Coalition were incorporated in this report, as appropriate.

We are sending copies of this report to Senator Tom Harkin, Ranking Minority Member, Senate Committee on Agriculture, Nutrition and Forestry; Representative Larry Combest, Chairman, and Representative Charles Stenholm, Ranking Minority Member, House Committee on Agriculture; Representative Gary A. Condit, Ranking Minority Member, Subcommittee on Risk Management, Research, and Specialty Crops, House Committee on Agriculture; Representative Tom Bliley, Chairman, House Committee on Commerce; the Honorable William Rainer, Chairman, CFTC;

the Honorable Arthur Levitt, Chairman, SEC; and other interested parties. We will also make copies available to others upon request.

If you or your staff have any questions regarding this report, please contact me at (202) 512-8678 or Cecile O. Trop at (312) 220-7600. Key contributors to this report are acknowledged in appendix II.

Thomas J. McCool
Director, Financial Institutions
and Markets

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Abbreviations

CBOE	Chicago Board Options Exchange
CBT	Chicago Board of Trade
CEA	Commodity Exchange Act
CFTC	Commodity Futures Trading Commission
CME	Chicago Mercantile Exchange
FCM	futures commission merchant
FIA	Futures Industry Association
NFA	National Futures Association
OTC	over-the-counter
SEC	Securities and Exchange Commission

Comments From the Securities and Exchange Commission

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

DIVISION OF
MARKET REGULATION

March 9, 2000

Mr. Thomas J. McCool
Director, Financial Institutions and Market Issues
General Government Division
General Accounting Office
Washington, DC 20548

Dear Mr. McCool:

I appreciate the opportunity to comment on the General Accounting Office's ("GAO") draft report entitled CFTC and SEC: Issues Related to the Shad-Johnson Jurisdictional Accord ("Draft Report"). I believe the recommendations in the Draft Report represent a sound approach to addressing the complex issues associated with single stock futures.

As you know, Senators Lugar and Gramm recently asked the Securities and Exchange Commission ("SEC") and the Commodity Futures Trading Commission ("CFTC") to present by March 2, 2000, a detailed report addressing the desirability of lifting the current prohibition on single stock futures along with any legislative proposals. Congressmen Combest, Bliley, and Ewing made a similar request.

Although the agencies have worked diligently, cooperated closely, and approached the negotiations in good faith, we have not yet reached a detailed consensus on how to regulate single stock futures and the markets and intermediaries that trade them. The procedural and jurisdictional issues raised by the trading of single stock futures are extremely challenging, and we believe that further discussions are necessary to achieve a full resolution. We are committed to an ongoing dialogue with the CFTC and therefore support your recommendation to Congress that both agencies should continue their joint efforts.

The SEC and CFTC have agreed, however, that their continuing efforts should be guided by a number of broad principles and goals. Specifically, the agencies believe that single stock futures should be jointly regulated under a framework that fosters innovation in financial markets, maintains international competitiveness, encourages liquidity and transparency of trading, mitigates systemic risk, and assures high standards of investor and customer protection and market integrity. The agencies also believe that any solution must maintain consistent oversight of stock, options, futures, single stock futures, and the markets and intermediaries that trade them. Finally, the agencies concur that their system of joint regulation should avoid imposing any unnecessary costs or burdens or duplicative regulation on securities or futures markets or market participants.

Mr. Thomas J. McCool
March 9, 2000
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See p. 35.

As evidenced by the progress made thus far, the SEC believes that it is possible to craft a strong yet flexible regulatory framework for single stock futures. We also believe, however, that the Draft Report does not fully address all of the concerns and issues associated with single stock futures. In some instances, the Draft Report tends to oversimplify the complex solutions required to bridge the disparities now existing between securities and futures regulation.

Although the issues we face are resolvable, they are complex and not given to simple solutions. The SEC appreciates the profound and widespread consequences attached to the trading of single stock futures, and believes it would be irresponsible to permit such products to trade without fully resolving all outstanding issues. Therefore, we strongly believe that single stock futures should not be permitted to trade in the United States until a comprehensive framework has been developed and implemented. The adoption of temporary or piecemeal fixes to the fundamental regulatory disparities (i.e., insider trading, margin, customer suitability) is not an appropriate remedy – in fact, it could damage the integrity of our capital and derivatives markets and result in regulatory arbitrage.

In the end, our challenge lies not only in developing a strong regulatory framework, but also in having the foresight to make it flexible enough to accommodate market and product evolution. This is a difficult task to accomplish, and the complexity of the solutions will reflect the many issues we struggle with today.

Thank you again for this opportunity to provide comments to the GAO as it prepares its final draft of the report.

Sincerely,

Annette L. Nazareth

Annette L. Nazareth
Director

GAO Contacts and Staff Acknowledgments

GAO Contacts

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In addition to those named above, Roger E. Kolar, Richard S. Tsuhara, and Sindy Udell made key contributions to this report.

Related GAO Products

The Commodity Exchange Act: Issues Related to the Commodity Futures Trading Commission's Reauthorization (GAO/GGD-99-74, May 5, 1999).

OTC Derivatives: Additional Oversight Could Reduce Costly Sales Practice Disputes (GAO/GGD-98-5, Oct. 2, 1997).

The Commodity Exchange Act: Legal and Regulatory Issues Remain (GAO/GGD-97-50, Apr. 7, 1997).

Financial Market Regulation: Benefits and Risks of Merging SEC and CFTC (GAO/GGD-95-153, May 3, 1995).

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