

PEAVEY COMMODITY FUTURES FUND I, II, III

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Advisers Act Sec. 202(a)(11)

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Our Ref. No. 83-15-CC

Peavey Commodity Futures Funds, I, II, III

File No. 132-3

On December 7, 1981, the Securities and Exchange Commission (the "SEC") and the Commodity Futures Trading Commission (the "CFTC") announced an agreement (the accord) as to the appropriate scope of their respective jurisdictions. (S.E.C. Release No. 81-66, Dec. 7, 1981.) Subsequently, in February 1982, the two agencies submitted to Congress proposed legislation which embodied the essence of the accord, accompanied by a joint explanatory statement.¹ The proposed amendments to the federal securities and commodities laws were finally codified in Public Law No. 97-303, 96a Stat. 1409 (1982), and the Futures Trading Act of 1982, Pub.L. No. 97-444, 96 Stat. 2295 (1983) ("Futures Trading Act of 1982"), respectively.

Although neither the accord, the explanatory statement, nor the legislation enacted pursuant to the accord state that futures contracts on financial instruments and stock indices are not securities, they indicate that it was intended that the CFTC would have exclusive jurisdiction over futures contracts on exempted securities (other than municipal securities) and on broad-based groups or indices of any securities, and over options on any such futures contracts.² In addition, the Futures Trading Act of 1982 codifies the following three points as stipulated to in the accord³: (1) no trading will be permitted in futures contracts (or options on futures contracts) on individual corporate and municipal securities; (2) the SEC may allow options on foreign currency to trade on national securities exchanges, while the CFTC will have jurisdiction to regulate the trading of options on foreign currency in the commodities markets; and (3) the CFTC will consult with the SEC on any application submitted by a board of trade for designation as a contract market with respect to any futures contract on a group or index of securities.

The CFTC's exclusive jurisdiction pursuant to section 2(a)(1) of the Commodity Exchange Act ("CEA") over accounts involving futures on commodities or options thereon was made subject by the Futures Trading Act of 1982 to, among other things, the provision that the Securities Act of 1933 and the Securities Exchange Act of 1934 would apply to the issuance of securities by commodity pools (see section 103 of the Futures Trading Act of 1982 adding new subsection (2) to section 4m of the Commodity Exchange Act). With respect to this change, the joint explanatory statement said:

While the CFTC has adopted extensive regulations governing the activities of commodity pool operators and has exclusive jurisdiction with respect to "accounts * * * involving" futures, the SEC has taken the position that the activities of a commodity pool as a company, i.e. its formation, capital raising, and continued corporate existence are subject to the federal securities laws. The draft legislative language would make this result explicit by stating that nothing in the CEA affects the applicability of the Securities Act and the Exchange Act with respect to securities issued by commodity pools and transactions therein. Of course, the proposed language would not affect the exclusive jurisdiction granted by the CEA with respect to state regulation. Moreover, in appropriate circumstances, commodity pools and persons managing them may be subject to the Investment Advisers Act of 1940 and if a pool conducts not only a commodities business but also acts as an investment company, the Investment Company Act of 1940 (emphasis added).⁴

The Senate Agricultural Committee said with respect to the same amendment:

The new amendment does not imply that the Investment Company Act of 1940 and the Investment Advisors [sic] Act of 1940 are applicable to the activities of commodity pools, commodity pool operators, and commodity trading advisors when such entities or persons purchase commodity futures contracts (or options thereon) based on securities or give advice as to the purchase and sale of futures contracts (or options thereof) based on securities.⁵

It appears, therefore, that without regard to whether futures on securities or options on such futures are securities, an entity investing in such interests is not subject to the jurisdiction of the SEC under the Investment Company Act of 1940 unless such entity is otherwise an investment company under the Investment Company Act, in which case the person advising the investment company about its investments in futures may be an "investment adviser" of an investment company" under section 2(a)(20) of the Investment Company Act⁷ and its contract subject to the provisions of section 15 of the Investment Company Act. A person giving advice concerning the making of investments in futures on exempted securities (other than municipal securities) or in futures on indices of securities as permitted pursuant to the Futures Trading Act of 1982, or as previously approved by the CFTC, or on options on such futures is excluded by the CEA from being subject to the jurisdiction of the SEC under the Investment Advisers Act of 1940 unless the person provides advice about investing in securities, otherwise than by advising about such futures or options on such futures or about certain securities which may be termed, generally, United States government securities.⁸

In determining whether an entity which invests in futures, including futures in exempted securities and futures on indices of securities, and options on such futures, is otherwise an investment company, one must determine first whether the entity is otherwise within the definition of an investment company contained in section 3(a) of the Investment Company Act. Generally, this would require a determination of whether the entity was, otherwise than by its investment in such futures or options on such futures, either primarily engaged in investing in securities so as to be an investment company under section 3(a)(1) of the Investment Company Act, or on an entity with more than 40 percent of its total assets (exclusive of Government securities and cash items) in investment securities so as to be an investment company within section 3(a)(3) of the Investment Company Act.

If the entity was not an investment company within the meaning of section 3(a)(1), but was within 3(a)(3), the entity would, nevertheless, still not be an investment company if it was excepted by section 3(b)(1) as an entity which was primarily engaged, directly or through a wholly-owned subsidiary, in a business or businesses other than trading in securities. In applying this provision to an entity engaged in investing in the aforementioned futures or options on such aforementioned futures, we would, in accord with section 2(a)(1) of the CEA, consider the entity not to be subject to SEC jurisdiction under the Investment Company Act if it was directly or indirectly primarily engaged in the business of investing in futures including the aforementioned futures and options thereon.

In determining an entity's primary engagement one usually looks to the composition of its assets, the sources of its income, the activities of its officers and employees, its representations, and its historical development. The first two of these factors are usually regarded as the most telling. However, it has been recognized that with respect to a commodity pool, a snapshot picture of its balance sheet contrasting the value of its future contracts (unrealized gain on such contracts) with the value of its other assets, e.g., its reserves and margin deposits, which often are in the form of United States government notes, may not reveal the primary nature of the business. In other words, the fact that such an entity, otherwise than by reason of its investment in futures, has more than 50 percent of its assets in securities would not necessarily indicate that it is primarily engaged in investing in securities. See, Alpha-Delta Fund (pub. avail. May 4, 1976).

In determining whether an entity investing in futures was otherwise primarily engaged in the business of investing in securities, we would consider of first importance the area of business in which the entity anticipates realization of the greatest gains and exposure to the largest risks of loss. Thus, at least with respect to such a company, a company's intentions are of great importance in determining its primary business. However, a company's real intentions may be revealed by its operations and, therefore, its gains and losses in futures trading, in comparison to its gains and losses on its government securities and other securities would be relevant to a determination of the company's primary business. Such a comparison on an annual, or other suitable basis, may be more revealing of a company's primary business than a comparison of the company's net gains or losses in futures and options on futures trading with its net gains or losses in investing in securities, otherwise than by reason of investing in futures and options on futures, which figures would be affected by the company's relative degree of success in these different areas.

We note that as previously indicated,¹⁰ there is a ban against trading futures on individual corporate and municipal securities and our position and interpretation does not apply to such interests.

Based upon the foregoing, and in accordance with the terms of the accord and the legislation enacted pursuant hereto, we would not recommend that the Commission take any enforcement action under the following:

(A) the Investment Company Act if, without registering under the Act, Peavey Commodity Futures Funds I, II, and III (the "Funds") invest in (1) futures contracts on securities, which contracts were approved by the CFTC prior to the enactment of the Futures Trading Act of 1982 or are approved by the CFTC in conformance with the accord and the legislation embodying the accord, (2) futures contracts on stock indices, which contracts also were approved by the CFTC prior to enactment of the Futures Trading Act of 1982 or are approved by the CFTC in conformance with the accord and the embodying legislation, and (3) options on such futures contracts and options on physical commodities traded on contract markets designated by the CFTC (the interests mentioned in (1), (2) and (3) are referred to hereinafter as "approved futures and CFTC options"), and the Funds' trading advisers do not comply with section 15 of the Investment Company Act, provided that the Funds are not otherwise engaged in the business of investing in securities so as come with the definition of an investment company contained in section 3(a) of the Investment Company Act; and

(B) the Investment Advisers Act if, without registering under such Act, the Funds' trading advisers provide the Funds with advice concerning approved futures and CFTC options, provided that such advisers are not otherwise investment advisers as defined in the Investment Advisers Act who are required to register under the Investment Advisers Act.

Stanley B. Judd
Deputy Chief Counsel

Footnotes

1 See, S.E.C. Release No. 82-9 (Feb. 2, 1982) and H.R. REP No. 626 Pt. II, 97th Cong., 2d Sess. 10-16 (1982).

2 H.R. REP. No. 565 Pt. I, 97th Cong., 2d Sess. 38 (1982), and 7 U.S.C. § 2, as amended by Futures Trading Act of 1982, § 101(a)(3).

3 Futures Trading Act of 1982 sections 101(a)(3)(B)(iv), (v) and 102.

4 H.R.REP. No. 626 Pt. II, 97th Cong., 2d Sess. 14 (1982). Note that the Senate Report on S. 2260, the bill originally introduced pursuant to the accord to amend the securities laws (corresponding to H.R. 6156 enacted as Pub.L. No. 97-303), makes the same statement. S.REP. No. 390, 97th Cong., 2d Sess. 7 (1982).

5 S. REP No. 384, 97th Cong., 2d Sess. 82 (1982).

7 Under this section, to be an investment adviser of an investment company, it is not necessary for a person to give advice about securities; advice with respect to the desirability of investing in any property would suffice.

8 A person giving advice only with respect to securities which are direct obligations of or obligations guaranteed as to principal or interest by the United States, or securities issued or guaranteed by corporations in which the United States has a direct or indirect interest which shall have been designated by the Secretary of the Treasury pursuant to section 3(a)(12) of the Securities Exchange Act of 1934 as exempted securities for the purposes of that Act, is excepted from the definition of "investment adviser" by clause E of section 202(a)(11) of the Investment Advisers Act.

10 See discussion at p. 1 supra.

INCOMING LETTER

January 12, 1983

**Office of the Chief Counsel
Division of Investment Management
Securities and Exchange Commission
450 5th Street, N.W.
Judiciary Plaza
Washington, D.C. 20549**

Attention: Sidney L. Cimmet, Esq.

**Re: Peavey Commodity Futures Fund I (No. 0-9497)
Re: Peavey Commodity Futures Fund II (No. 0-10149)
Re: Peavey Commodity Futures Fund III (No. 2-76259)**

Gentlemen:

Peavey Commodity Futures Funds I, II and III (the "Funds") are public commodity pools organized in 1980, 1981, and 1982 respectively under the Illinois Uniform Limited Partnership Act. Units of limited partnership interest of each Fund were registered with the Securities and Exchange Commission (the "SEC") on Form S-1 and were offered to the public by registered broker-dealers who were members of the National Association of Securities Dealers, Inc. Each of the Funds was organized to engage in the speculative trading of commodity futures contracts and other commodity interests. Trading decisions for Peavey Commodity Futures Fund I and II are made by Elam Management Corporation and trading decisions for Peavey Commodity Futures Fund III are made by Dean Corporation. Both Elam Management Corporation and Dean Corporation (the "Advisors") are registered as commodity trading advisors with the Commodity Futures Trading Commission ("CFTC"). The general partner of the Funds is Peavey Futures Management Corporation ("PFMC"), a wholly-owned subsidiary of the commodity broker of the Funds, Peavey Company. PFMC is registered as a commodity pool operator, and Peavey Company is registered as a futures commission merchant with the CFTC.

The trading policies of the Funds restrict trading in financial instrument futures contracts to those five types of contracts specified in the "no-action" letter concerning Boston Futures Fund (I) issued by the Division of Investment Management on October 12, 1979 (Ref. No. 79-362-CC) (attached as Exhibit A). Trading in other financial instrument contracts is prohibited until the SEC no longer takes the position that trading in such contracts may require registration by the Funds under the Investment Company Act of 1940 and by the Advisors under the Investment Advisers Act of 1940 or until the matter, in the opinion of counsel to the Funds, has been settled by controlling precedent to the effect that such Acts are not applicable to such contracts (the Investment Company Act of 1940 and the Investment Advisers Act of 1940 are hereinafter referred to as "the 1940 Acts").

As a result of developments since the issuance of the Boston Futures Fund (I) no-action letter, including recent revisions to the securities and commodity laws, Peavey Commodity Futures Funds I, II and III and the Advisors respectfully request that the staff issue a "no-action" letter with respect to the non-registration of the Funds and the Advisors under the 1940 Acts as more fully described below. This firm is counsel to Peavey Commodity Futures Funds I, II and III and has been authorized to sign this letter on behalf of Townley & Updike, counsel to Elam Management Corporation and Dean Corporation.

Authorization and Consideration by CFTC of Additional Financial Instrument Contracts and Options

Since the issuance of the Boston Futures Fund (I) no-action letter in 1979, many additional financial futures contracts have been authorized by the CFTC for trading on designated contract markets (commodity exchanges). These include futures contracts on bank certificates of deposit, on Eurodollar certificates and, most recently, on broad-based stock indices. Numerous additional financial futures

contracts have been proposed by commodity exchanges and are currently under review by the CFTC. In October, 1982, options on certain futures contracts began trading pursuant to a pilot option trading program approved by the CFTC.* Additional options contracts, including options on stock-index futures contracts, have been proposed by commodity exchanges and are currently under review by the CFTC.

Commodity pools have been discouraged or even prohibited from participating in many of these newly authorized futures and options contracts because the no-action position of the SEC expressed in the Boston Futures Fund (I) letter was restricted to the five types of futures contracts listed therein (Treasury Bonds, Treasury Notes, Treasury Bills, GNMA certificates and commercial paper). This has had a significant impact on the commodity markets because commodity pools now provide an increasingly important means of public participation in the commodity markets. In addition, financial instrument contracts have had the greatest growth in volume of any group of futures contracts and now constitute a substantial portion of total commodity futures volume.

Jurisdictional Accord between SEC and CFTC

On December 7, 1981, the SEC and the CFTC announced their agreement on a range of issues regarding their respective jurisdictions. The agencies have released a joint explanatory statement setting forth their proposed resolution of the jurisdictional confusion which had grown out of the proliferation of new securities and commodity products. This jurisdictional accord (attached as Exhibit B) was not only a pronouncement of the positions of the two agencies but also formed the basis for seeking Congressional ratification of the SEC-CFTC jurisdictional resolution.

In the accord, it was agreed that the SEC will regulate options on securities, on certificates of deposit, and on all indices of securities or certificates of deposit. The CFTC will regulate futures contracts on exempted securities (other than municipal securities) and on broad-based indices of any securities, as well as options on any such futures contracts. Both agencies agreed to specific standards governing CFTC designation of a contract market for futures on stock indices. Authority for regulation of foreign currency options would depend upon whether the trading took place on securities exchanges or in the commodity markets.

The jurisdictional accord is widely regarded as an important step toward defining the jurisdictional lines between the two agencies. As described in the following section, Congress accepted the legislative proposals made by the two agencies and enacted legislation ratifying the substance of the accord.

Congressional Ratification of Jurisdictional Accord

In extensive hearings conducted in 1982, Congress considered the jurisdictional accord reached between the SEC and CFTC. Ratification of the accord would involve amendments to both the securities and commodity laws. As discussed below, Congress passed and the President signed legislation (H.R. 6156) amending the securities laws affected by the ratification of the jurisdictional accord. Corresponding revisions to the commodity laws were reported out of the Conference Committee, which also considered other amendments resulting from hearings held to consider the reauthorization of appropriations for the CFTC. On January 11, 1983, President Reagan signed into law the Futures Trading Act of 1983, which incorporates those revisions to the commodity laws.

The principal revision to the securities laws in H.R. 6156 which has been enacted was to the definition of a "security." That definition, found in the Securities Act of 1933, Securities Exchange Act of 1934 and the 1940 Acts, now expressly includes

any put, call, straddle, option or privilege on any security, certificate of deposit, or group or index of securities (including any interest therein or based on the value thereof), or any put, call, straddle, option, or privilege entered into on a national securities exchange relating to foreign currency ...

These amendments remove any doubt that the SEC has the authority to regulate options on securities, certificates of deposit, stock indices, and foreign currencies. The Futures Trading Act of 1982 complements these revisions to the securities laws by ratifying the jurisdictional accord with respect to

exclusive CFTC authority to regulate futures contracts, including futures contracts on securities and stock indices, and options thereon.

The Futures Trading Act of 1982 amends Section 2(a)(1) of the Commodity Exchange Act by adding a new subparagraph (B)(ii) which grants to the CFTC exclusive jurisdiction:

with respect to accounts, agreements (including any transaction which is of the character of, or is commonly known to the trade as, an 'option', 'privilege', 'indemnity', 'bid', 'offer', 'put', 'call', 'advance guaranty', or 'decline guaranty') and transactions involving, and may designate a board of trade as a contract market in, contracts of sale (or options on such contracts) for future delivery of a group or index of securities (or any interest therein or base upon the value thereof) ...

The Futures Trading Act of 1982 specifies the guidelines for CFTC approval of such options and futures contracts. These guidelines give the SEC certain authority with respect to approval of a futures contract on a stock index (or option thereon) prior to trading of the contract. The legislative history to the Futures Trading Act of 1982 makes clear that the CFTC retains exclusive authority to regulate all aspects of trading in such contracts after such contracts are approved.

Under the Futures Trading Act of 1982, the CFTC would not be permitted to designate a contract market to trade futures contracts (or options thereon) on corporate or municipal securities. Currently there are no futures contracts or options contracts on corporate or municipal securities approved for trading. Consequently, all existing futures contracts and options contracts traded on commodity exchanges fall within the jurisdiction of the CFTC. There is no indication in the legislative history of the Futures Trading Act of 1982 or of H.R. 6156 that Congress intended existing futures contracts including futures contracts on securities to be regulated by the SEC. Accordingly, existing futures contracts approved for trading, including futures contracts on certificates of deposit and on Eurodollar certificates, would remain within the exclusive jurisdiction of the CFTC.

Need For No-Action Position

Since the issuance of the Boston Futures Fund (I) no-action letter, futures contracts on Eurodollar certificates, on certificates of deposit, and on stock indices as well as options on financial futures contracts have been authorized by the CFTC and are now traded on designated contract markets. In view of (i) the proliferation of new commodity contracts, (ii) the jurisdictional accord between the SEC and the CFTC, and (iii) statutory ratification of the accord, an extension of the Boston Futures Fund (I) no-action letter is appropriate. A no-action position would essentially reflect recent changes in the securities and commodity laws and, at the same time, would eliminate any inconsistencies and gaps between the new legislation and the Boston Futures Fund (I) no-action letter. Of course, pertinent provisions of the Commodity Exchange Act and regulations of the CFTC, including registration, disclosure, anti-fraud, and recordkeeping requirements, would continue to apply to the Funds and the Advisors. In addition, the Securities Act of 1933 and the Securities Exchange Act of 1934 would continue to apply to the Funds.

Therefore, for the reasons stated, Peavey Commodity Futures Funds I, II and III and the Advisors respectfully request that the Division of Investment Management of the SEC issue a no-action letter to the effect that registration by the Funds and by the Advisors under the 1940 Acts is not required for trading in (i) futures contracts on securities which contracts have been approved by the CFTC or are approved by the CFTC in conformity with the jurisdictional accord and the legislation ratifying such accord, (ii) futures contracts on stock indices, and (iii) options on both futures contracts and physical commodities traded on contract markets designated by the CFTC. The provisions of 17 CFR § 200.81(a) (1978) are hereby waived and the SEC is authorized to make this letter and its interpretive response public whenever it so chooses and without regard to the thirty day non-publication rule.

Very truly yours,

ABRAMSON & FOX
Mark H. Mitchell

* Under the pilot program, one type of options contract may be traded on each exchange. Currently, the Chicago Board of Trade trades options on Treasury Bond futures, the International Monetary Market of the Chicago Mercantile Exchange trades options on Treasury Bill futures, the Coffee, Sugar and Cocoa Exchange trades options on sugar futures, and the Commodity Exchange of New York and the Mid-America Commodity Exchange trade options on gold futures.

ENCLOSURE

October 12, 1979

EXHIBIT A

**Our Ref. No. 79-362-CC
Boston Futures Fund (1)
Registration Statement on Form S-1 (No. 2-64952)**

The term "Security", as defined in the Investment Company Act of 1940 ("Investment Company Act") and the Investment Advisers Act of 1940 ("Advisers Act"), includes a right to purchase a security. For this reason and others, a futures contract on a security may itself be deemed to be a security.

A company primarily engaged in investing in securities is an investment company subject to the provisions of the Investment Company Act, and a person who gives advice, for compensation, about securities is an investment adviser subject to the provisions of the Advisers Act.

The exclusive jurisdiction granted the Commodity Futures Trading Commission ("CFTC") by section 2 of the Commodity Exchange Act ("CEA") with respect to accounts, agreements, and transactions involving contracts of sale of a commodity for future delivery, traded or executed on a designated contract market or any other board of trade, exchange, or market, and transactions with respect to leverage contracts, does not necessarily remove a fund which is primarily engaged in the business of investing in futures on securities, or a person who gives advice about such futures, from the provisions of other laws which are otherwise applicable to them, such as the securities laws.

Section 2 of the CEA provides that except for the exclusive jurisdiction granted the CFTC in the areas stated, nothing in that section shall supersede or limit the jurisdiction at any time conferred on the Securities and Exchange Commission or other regulatory authorities under the laws of the United States or of any State, or restrict the Securities and Exchange Commission and such other authorities from carrying out their duties and responsibilities in accordance with such laws. In this regard, interests in the Fund have been registered under the Securities Act of 1933 ("1933 Act").

However, the Securities and Exchange Commission's traditional areas of regulatory concern, as opposed to anti-fraud concern, have not included United States Treasury Bills, United States Treasury Notes, United States Treasury Bonds, Government National Mortgage Association certificates, and commercial paper, all of which are exempt from the registration requirements and certain other provisions of the 1933 Act. For this reason, and in view of the purposes of the provisions of the CEA which are applicable to the Fund and to the Advisor, i.e., the regulation of commodity pool operators and commodity trading advisors, we would not recommend that the Commission take any action under the Investment Company Act or the Advisers Act against the Fund or the Advisor by reason of their proceeding as indicated and investing in, or giving advice with respect to, futures contracts on commodities without the Fund's registering under the Investment Company Act or the Advisor's registering under the Advisers Act. This position is conditioned on any investment by the Fund in futures contracts on financial instruments, and any advice given by the Advisor about futures contracts on financial instruments, being limited to futures contracts on United States Treasury Bills, United States Treasury Notes, United States Treasury Bonds, Government National Mortgage Association certificates, and commercial paper. Nothing contained in this letter should be construed to suggest that registration under the Investment Company Act or the Advisers Act would not be required if the Fund invested in, or the Advisor gave advice with

respect to, futures contracts on any other type of security.

Stanley B. Judd
Assistant Chief Counsel

ENCLOSURE

EXHIBIT B

Commodity Futures Trading Commission Securities and Exchange Commission

JOINT EXPLANATORY STATEMENT

As announced on December 7, 1981, the Commodity Futures Trading Commission ("CFTC") and the Securities and Exchange Commission ("SEC") have come to an agreement on a range of issues regarding their respective jurisdictions. In connection with this effort, the agencies have prepared draft legislation which, among other things, would clarify the statutes administered by the two agencies. The CFTC and the SEC are transmitting the draft legislative proposals to their respective Congressional committees, with this Statement, which explains a number of issues relating to the agreement. The two agencies urge that these statutory changes be enacted as promptly as possible.

The desirability of a resolution by the two agencies of the issues between them has become increasingly clear. The growing demand for new products related to securities or financial instruments, either as investments or as price hedging tools, has magnified the importance of removing the jurisdictional confusion that has hampered the development of the markets for such instruments. The confusion is a result essentially of amendments in 1974 to the Commodity Exchange Act (the "CEA") that (1) expanded the definition of "commodity" to embrace not only tangible goods but to reach intangible rights and interests, (2) gave the CFTC "exclusive jurisdiction" over agreements and transactions "involving" futures trading in commodities, and (3) inserted in the CEA a qualified proviso to preserve the SEC's preexisting authority over securities trading and the securities markets.

Summary

The two agencies have agreed that the SEC will regulate options on securities and on certificates of deposit (and on all groups or indices of securities or certificates of deposit) and the CFTC will regulate futures contracts on exempted securities (other than municipal securities) and on broad-based groups or indices of any securities, as well as options on any such futures contracts. No futures contracts (or options on futures contracts) on individual corporate and municipal securities will be permitted to trade. The SEC may also allow options on foreign currency to trade on national securities exchanges, while the CFTC will have jurisdiction to regulate the trading of options on foreign currency in the commodities markets. The attached legislative proposals would specifically codify the agreement of the two agencies by clarifying current law in certain areas.

Options on securities

Since 1973, national securities exchanges have traded options on securities under the regulatory structure administered by the SEC. The proposals to amend the federal securities laws would relate to the SEC's authority to regulate trading in options on securities. The SEC's authority over such trading on exempted securities has been challenged in the United States Court of Appeals for the Seventh Circuit.¹ Thus, one proposal would clarify the definition of "security" in the federal securities laws to include explicitly any option on a security.² In addition, options on foreign currency traded on a national securities exchange and options on certificates of deposit³ would be included within that definition. Under the proposals, the SEC's authority over the trading of securities options also would be clarified by an amendment to Section 9(f) to establish specifically that the SEC's plenary options authority in Section 9(b) of the Exchange Act extends to options on exempted securities and by the addition of Section 9(g)

which confirms the SEC's authority to regulate the trading of options on all securities and on certificates of deposit. The same legislative proposal would provide that only the SEC, and not the CFTC, has authority with respect to options directly on underlying securities and securities groups or indices.

Under a series of proposed amendments to the federal commodity laws, the CEA would not apply to options on securities or securities aggregates, and the CFTC would not be permitted to designate a board of trade as a contract market for the trading of such instruments. Nevertheless, the CFTC would have exclusive jurisdiction over all permissible futures contracts as well as options on those futures contracts, and would regulate options directly on foreign currencies traded in the commodity markets (but not on a national securities exchange).

Futures on individual corporate or municipal securities

Pending further review of appropriate regulatory systems for trading in such futures, the legislative proposal would foreclose the trading of futures (and options on futures) on individual corporate or municipal securities, or contracts based on the value of such a security. Nevertheless, the two agencies intend to study further the issues raised by such trading with a view toward a future recommendation to lift this restriction. This temporary foreclosure of trading does not apply to futures (or options on futures) on exempted securities, except municipal securities.

Futures on securities indices

The CFTC would be permitted under proposed amendments to the CEA to designate a board of trade as a contract market for contracts (or options on such contracts) of sale for future delivery of a securities group or index, but only if the contract (or option on such contract) meets certain specific minimum requirements set forth in the draft legislation as well as other requirements currently in the CEA.

With respect to a futures contract on a securities group or index (or option on such contract), settlement must be effected in cash or by means other than a security on which a futures contract could not be authorized. That is, such a contract could be settled by delivery of an exempted security, such as a security issued or guaranteed by the United States government, but could not be settled by the transfer or receipt of a corporate or municipal security.

Separate and apart from the present statutory requirement that any contract market have rules to prevent manipulation, the CFTC also would be required to find that trading in the contract under consideration would not be likely to produce manipulation in the futures markets or in related markets, i.e., those for any underlying security, option on such security, or option on a group or index including such securities.⁴

A securities group or index underlying a futures contract must be predominantly composed of the securities of unaffiliated issuers and, in addition, would be required to be a widely published measure of, and to reflect, the market for all publicly-traded equity or debt securities or a substantial segment of such market, or be comparable to such a measure. This standard is intended to provide adequate flexibility for the market to respond to the needs of participants, while assuring that only broad-based securities index futures contracts that are not conducive to manipulation could be authorized.⁵

In view of the SEC's strong regulatory concern with respect to the trading of futures on securities groups and indices, that agency would be provided a specific role in the process of CFTC designation of a contract market for the trading of such instruments.⁶ The CFTC would be required to consult with the SEC with respect to designation of any board of trade as a contract market for any futures contract involving a securities group or index. Following a mandatory public comment period, the SEC would be provided with a specific time period during which it could object to the designation on the ground that any minimum requirement was not met. If the SEC objected, the CFTC would, if the SEC requested, afford it an opportunity, after the public comment period, for an oral hearing prior to action upon the designation. After the oral hearing, if the SEC continued to maintain its objections, the CFTC would be required to give appropriate weight to the SEC's views in deciding whether to authorize the contract. If, nonetheless, the CFTC designated a board of trade as a contract market for such a futures contract,⁷ the SEC would have the right to judicial review of such order, at which time the court would consider the CFTC's action and the SEC's views. In reviewing the CFTC action, the court would be required to

determine, in accordance with the standards of Section 6(b) of the CEA, whether the agency action was supported by the weight of the evidence.

Commodity pools

While the CFTC has adopted extensive regulations governing the activities of commodity pool operators and has exclusive jurisdiction with respect to "accounts * * * involving" futures, the SEC has taken the position that the activities of a commodity pool as a company, i.e., its formation, capital-raising, and continued corporate existence, are subject to the federal securities laws. The draft legislative language would make this result explicit by stating that nothing in the CEA affects the applicability of the Securities Act and the Exchange Act with respect to securities issued by commodity pools and transactions therein. Of course, the proposed language would not affect the exclusive jurisdiction granted by the CEA with respect to state regulation. Moreover, in appropriate circumstances, commodity pools and persons managing them may be subject to the Investment Advisers Act of 1940 and, if a pool conducts not only a commodities business but also acts as an investment company, the Investment Company Act of 1940.

Footnotes

1 Board of Trade of the City of Chicago v. Securities and Exchange Commission, et al., No. 81-1660 (7th Cir., petition for review filed April 24, 1981), (No. 81-2587 (7th Cir., petition for review filed October 5, 1981); and No. 82-1097 (7th Cir., petition for review filed January 21, 1982).

2 As a result, an option on an exempted security would expressly be a separate, non-exempted security. Accordingly, a person in the business of effecting transactions in such instruments would, absent an applicable exemption, be required, pursuant to Section 15 of the Securities Exchange Act of 1934 (the "Exchange Act"), to register with the SEC as a broker or dealer. To the extent, however, that such a requirement would impose an unnecessary burden on government securities dealers effecting transactions in options on government securities, the SEC has the authority administratively to provide an exemption from that requirement and currently intends to do so.

3 Although the status of certificates of deposit as securities under the Securities Act of 1933 (the "Securities Act") and the Exchange Act is not free from doubt, certificates of deposit have consistently been considered "securities" for the purposes of the Investment Company Act of 1940. In order to emphasize that no change in current law is contemplated, the legislative language used in the two circumstances differs. Thus, for investment company purposes, the relevant portion of the definition of security would read " * * * option * * * on any security including a certificate of deposit," while the corresponding language proposed in the Securities and Exchange Act would read " * * * option * * * on any security, or certificate of deposit * * *."

4 In order to address concerns relating to the general possibility of inter-market manipulation, the agencies have recommended the CEA be amended to authorize the CFTC to provide trade information to securities self-regulatory organizations and to registered futures associations, as well as to contract markets.

5 In practice, the two agencies believe that these standards will raise few substantial questions with respect to trading futures on established, widely-used indices containing a number of securities sufficient so that the indices will not be subject to manipulation. As one example, an index of most of the securities traded on a major national securities exchange would appear unlikely to present difficulties. Such indices also would seem more likely to be useful to the marketplace, since they would permit persons such as underwriters or portfolio managers to hedge the risk of overall market movements. However, it appears unlikely that indices not now in existence, based on bonds issued by a group of affiliated companies or on small industry groups, would meet such standards.

6 Section 2(a)(8) of the CEA provides a procedure for CFTC solicitation of comments from the U.S. Department of the Treasury and the Board of Governors of the Federal Reserve System ("FRB") with respect to futures contracts involving securities issued or guaranteed by the U.S. government. As agencies concerned with the issuance of such securities and with monetary policy and debt management, the Treasury Department and the FRB clearly have an interest in the CFTC's designation

of a market for futures on such instruments. Nevertheless, the SEC, as the regulator of trading markets in municipal and corporate securities, has an even more direct interest in the authorization of a related futures market. Thus, the involvement of the SEC in the designation process is intended to go beyond the relatively informal communications procedure established for the Treasury Department and the FRB.

7 If the CFTC refused to grant the application for designation and, pursuant to the CEA, afforded the board of trade an opportunity for a hearing on the record, the SEC would have the right to participate in that hearing as an interested party. Thus, the SEC would be permitted to present evidence and its views and to challenge the arguments advanced by the board of trade in support of its application.