TESTIMONY OF WILLIAM J. BRODSKY
CHAIRMAN AND CHIEF EXECUTIVE OFFICER
CHICAGO BOARD OPTIONS EXCHANGE

CONCERNING THE ADMINISTRATION'S FINANCIAL REGULATORY REFORM PROPOSAL

COMMITTEE ON FINANCIAL SERVICES
UNITED STATES HOUSE OF REPRESENTATIVES

July 17, 2009

Mr. Chairman and members of the Committee, I am William J. Brodsky, Chairman and Chief Executive Officer of the Chicago Board Options Exchange, Inc. ("CBOE"). For the past 35 years, I have served in leadership roles at major U.S. stock, futures and options exchanges, including 11 years as CEO of the Chicago Mercantile Exchange and 12 years in my current role as CBOE Chairman and CEO.

Exchange-traded options have become a major component of the U.S. -- and the world's -- financial markets. In 2008 over 3.6 billion options contracts traded on the seven U.S. options exchanges, an increase of 25% over 2007. This was the fifth consecutive year that volume growth has exceeded 25%. The annual number of contracts traded has tripled over that five-year period, outstripping the growth in both stock and futures trading. This dramatic growth is a reflection of the expanding use of options as a tool for managing the risk of owning stocks, Exchange Traded Funds (ETFs) and mutual funds and also reflects the highly competitive environment in which exchange-traded options are traded.

In addition to my role at CBOE, I am currently serving as chairman of the World Federation of Exchanges (WFE), a 49-year old organization, which is based in Paris and includes over 50 of the world's major regulated stock, futures and options exchanges. WFE promotes the highest standards of market integrity by working on a global basis with policy makers, regulators and government organizations for fair, transparent and efficient markets. The fact that the CEO of a derivatives exchange has been elected Chairman of the WFE illustrates the heightened role that exchange-traded derivatives now play in the global financial system.

Throughout my career at exchanges, I have witnessed and participated in many meaningful improvements in the efficiency, functionality and value of our exchange markets. Following the 1987 stock market crash, U.S. exchanges made significant enhancements to market infrastructure and resiliency, but very little changed in the way of regulatory oversight despite the Brady Report, the seminal presidential study of the crash, which found that our regulatory system was already sorely outmoded when the markets fell precipitously in 1987.[1]

The regulatory system deemed antiquated in 1987 remains in place today, but now labors under the weight of increasingly sophisticated technology and instruments that trade around the world in less than a blink of an eye. The ongoing failure to modernize our regulatory system has resulted in a disjointed,

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[1] See attached *The Wall Street Journal* op-ed of October 19, 2007, "A Real Regulatory Redundancy."

overlapping situation that causes bottlenecks in some markets, unregulated gaps in others, and lacks entirely an overarching regulatory perspective.

While reasonable people may disagree on the best ways to create a 21st century system for market regulation, there is clearly a national consensus that retaining the status quo is not an option. Congress should not squander the opportunity afforded by this broad public consensus to design and mandate regulatory reforms that are long overdue.

I am honored to share our perspective in today's testimony on the Administration's proposal for financial regulatory reform ("Reform Proposal"). At the outset, I would like to commend the Administration for the progress made in drafting a proposal that seeks comprehensive regulatory reform. My testimony will focus primarily on the harm caused by the split jurisdiction between securities and futures in the U.S. and the partial, but incomplete, steps the Reform Proposal takes to address this situation. I will touch on certain other aspects of the Reform Proposal of particular interest to CBOE, as well.

Throughout the financial crisis of the past year, regulated exchanges, not only in the U.S. but also around the world, provided important investor safeguards, such as transparency, price discovery, certainty of execution and protection against counterparty risk through centralized clearing. Despite credit failures, bank and brokerage meltdowns, extreme market volatility, and the imposition of emergency short sale rules, exchanges continued to provide transparent, liquid and orderly marketplaces – without interruption – and continued to fulfill the essential functions of capital formation and risk management. In the midst of a financial tsunami when precious few financial institutions "worked," regulated exchanges promised as delivered: no failures, no closures, no taxpayer rescues.

The reliability of regulated exchanges amidst recent market turmoil belies the fact that the ongoing effectiveness of many of our nation's exchanges is severely compromised by the yoke of a cumbersome regulatory system. Indeed, perhaps no area of regulation has longer been in need of a structural fix than that of the bifurcated system of regulating exchange-traded financial products in the U.S. To the extent that we ignore this reality, we place at peril the ongoing ability of the U.S. to operate and compete effectively in an increasingly global and sophisticated marketplace.

We are particularly gratified, therefore, that the Administration's Reform Proposal not only addresses the immediate and urgent issue of under-regulation of OTC derivatives, but also acknowledges the need to address those areas of existing regulation, such as the SEC/CFTC jurisdictional divide, which are dangerously antiquated.

It has become increasingly clear over the past two decades that our system of regulating securities and futures under two distinctly different statutory structures – with separate regulatory agencies and different congressional committees -- causes needless legal uncertainty and delay, impedes innovation and competition, and imposes unnecessary costs on our financial markets.

Since the enactment in 1974 of amendments to the Commodity Exchange Act, which gave the Commodity Futures Trading Commission ("CFTC") jurisdiction over all futures, there have been conflicts between the CFTC and the Securities and Exchange Commission ("SEC") as to their respective jurisdictions, particularly involving financial instruments that have elements of both securities and futures. This is a result of divided jurisdiction in which the SEC has oversight of "securities," including stocks, bonds, mutual funds and options on these instruments or an index of such instruments, and the CFTC has jurisdiction over "commodities," which is very broadly defined and includes futures on securities indexes or government securities.

The vesting of jurisdiction over futures and commodity options in the CFTC was developed at a time when the futures markets traded contracts almost exclusively on traditional commodities, such as agricultural products and metals, so that a separate agency sprung from the Department of Agriculture was deemed appropriate for this specialized segment of the market. However, the bifurcated system was already outmoded by the 1980s, when the "commodities" markets began trading contracts on a variety of financial instruments, including stock indexes, foreign currencies, and government securities. Attempts to clarify the jurisdictional boundaries of the SEC and CFTC, such as the Shad-Johnson Accord in 1982, merely addressed the then existing issues but in no way resolved the ongoing philosophical differences between the two agencies.

As the Reform Proposal clearly outlines, the differing missions of the SEC and CFTC, as well as the separate statutes under which they operate, mean that futures and comparable securities products are not regulated in a consistent manner. This has led to conflict between the agencies when both are involved in a default or malfeasance by a large market participant, as evidenced by the different approach the two agencies took two years ago with respect to the problems surrounding the failure of Sentinel Management Group, Inc.[2] In

[2] Sentinel was both an investment adviser registered with the SEC and a futures commission merchant registered with the National Futures Association. When questions arose as to the disposition of certain funds held by Sentinel on behalf of various futures commission merchants ("FCMs") and other clients, the SEC and the CFTC took very different positions. While the SEC sought to freeze the proceeds in all Sentinel accounts (which it asserted had been improperly commingled) for the ultimate benefit of injured investors (including, but not limited to, the affected FCMs), the CFTC sought to ensure that

addition, the lack of an insider trading prohibition for CFTC products potentially enables a miscreant to use such instruments to engage in transactions using inside information when otherwise prohibited from doing so using securities. This disparity will take on increasing importance with the growth of credit-related instruments. On an ongoing basis, the bifurcated regulatory system has led to persistent negative consequences for our markets -- it creates regulatory inefficiencies, hampers competitiveness, and impedes innovation. No other major country with well-developed derivatives markets uses a system of two different government agencies regulating equivalent financial products.

New Products

CBOE is known throughout the world as a wellspring of options innovation and has engineered virtually every major options innovation since launching the options industry in 1973. It is not surprising, therefore, that the most vexing aspect of the U.S. regulatory structure to CBOE is that the split jurisdiction and different governing statutes has led to delays in bringing new products to market. Legal uncertainties frequently arise because a novel aspect of a new securities derivative product could cause the CFTC to claim that the product has elements of a futures contract, and a novel aspect of a new futures product could cause the SEC to claim the product is a security. This can result in an interminable delay in bringing a new product to market while the two agencies try to decide who has jurisdiction over the instrument.

Product delays have occurred repeatedly over the past 20 years when CBOE attempted to introduce a novel product. For example, CBOE had two new product proposals -- one involving an option on an exchange traded fund that holds investments involving gold and one involving an option on a credit default product -- both placed on hold for an extremely long period of time (3½ years in the case of Gold ETFs and 7 months for the credit default product) because the two agencies could not agree on jurisdiction. In contrast, Eurex (Europe's largest derivatives exchange) was able to introduce a credit default product in Europe within weeks of announcing its intention to do so, and well before the U.S. exchanges had approval to introduce their credit default products in the U.S. due to the disagreement between the two agencies.

Clearing

Legal uncertainties caused by duplicative regulation also impede the clearing of new products. The Options Clearing Corporation (OCC), the clearing agency

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the FCMs were given access to their (or their customers') funds that had been in a segregated account in order to preserve the integrity of the futures markets and prevent a potentially broader, market-wide collapse.

for the seven U.S. options markets and the world's largest derivatives clearing house, clears exchange-traded derivative products and is registered with both the SEC and the CFTC. OCC clears securities options, which are under the jurisdiction of the SEC, security futures, which are jointly regulated by the SEC and CFTC, and futures, which are under the jurisdiction of the CFTC. OCC is the only U.S. clearing organization with the ability to clear all of these products within a single clearing organization, which provides for greater operational efficiency and, hence, reduces systemic risk in the clearing and settlement process. However, because of its dual registration, the OCC is subject to the jurisdiction of the CFTC, as well as that of the SEC, every time it introduces a new securities option product.

Although the CFTC operates under a self-certification process by which OCC could certify that a particular new product does not fall within the jurisdiction of the CEA, there are cases where there is genuine ambiguity as to where the jurisdictional line lies. In such cases, OCC has felt compelled to ask for prior approval of both agencies in order to avoid the risk of litigation after trading has begun. Split jurisdiction forces OCC to operate under this cumbersome process, thus inhibiting common clearing by a third party guarantor even though the benefits of centralized clearing were dramatically highlighted by the recent crisis. By contrast, futures exchanges and their captive clearing houses have no concomitant need to pre clear their new products with the SEC.

Margins

The problems from divided jurisdiction go beyond our pressing concerns about legal uncertainty for new products. U.S. financial firms are subject to duplicative and disjointed oversight from separate agencies when trading virtually equivalent products. Key investor protection and market soundness provisions, such as margin levels, are handled very differently by the two agencies for similar products. A concrete example of the harm this causes to our markets involves portfolio margining.

In 2007, the availability of portfolio margining was greatly enhanced for securities customers, including those who trade security futures, through expansion of an existing portfolio margin pilot program approved by the SEC. This expanded pilot includes equity options, security futures and individual stocks as instruments eligible for portfolio margining. The pilot enhances U.S. competitiveness by bringing the benefits of risk-based margining employed in the futures markets, and in most non-U.S. securities markets, to U.S. securities customers. The exchange rules adopting this pilot also authorized the inclusion of related futures positions in securities customer portfolio margining accounts.

The ability to margin all related instruments in one account would allow customers to fully realize the risk management potential of these instruments in a way that is operationally and economically efficient. However, legal impediments that prevent putting those futures positions in a securities customer portfolio margining account significantly undercut the ability of customers to fully realize the capital efficiencies of portfolio margining. For over four years, the SEC and CFTC have been unable to agree on how to permit futures to be included in a securities portfolio margin account. Because the two agencies continue to disagree on the most appropriate approach to implementing portfolio margining, the ability of many customers to employ portfolio margining between futures and securities has been stymied. Unless this deadlock is broken, portfolio margining will not reach its full potential in the United States, even though it is used in many jurisdictions abroad.

Financial Regulatory Oversight Council

We support the Reform Proposal's recommendation for the creation of a Financial Regulatory Oversight Council (FSOC), chaired by Treasury, to resolve potential disputes between the two agencies.

The FSOC would replace the President's Working Group on Financial Markets and maintain a permanent staff at Treasury. Among its responsibilities, the FSOC would help facilitate coordination of policy and resolution of disputes among the agencies. Currently, there is no real dispute mechanism in place other than sporadic dialogue between the two agencies. This has led to long delays in the decision-making process, which hinders competitiveness to the detriment of investors and our markets. This is not intended to imply that, when disputes do arise, either agency is not putting forth a good-faith effort to resolve them. Instead, each earnestly believes that it is properly applying its statute when analyzing a particular jurisdictional issue. The impasses that frequently arise may be the natural result of the differing, and sometime conflicting, philosophies of the securities laws and commodities laws. No matter how well intentioned the cause, a neutral arbiter is needed to resolve an impasse.[3]

We believe that the Treasury Department is well versed in the issues typically presented in jurisdictional disputes and is thus ideally suited to resolve them. Prompt resolution of jurisdictional disputes is extremely important to be able to bring new products to market quickly or to facilitate approval of new market mechanisms so that the U.S. capital markets can maintain their global

[3] Last year the SEC and CFTC entered into a Memorandum of Understanding ("MOU") on the review of products that raise jurisdictional issues. We believe that the MOU is not an effective mechanism to resolve jurisdictional disputes where the two agencies have strongly differing views on an issue.

competitiveness. In addition, we strongly recommend that the Exchanges, as self-regulatory organizations (SROs), be authorized to bring issues directly before the Council for resolution.

Harmonization

The Reform Proposal recognizes that split regulation is outmoded and harmful, and for this reason offers constructive steps toward addressing the situation. Specifically, the Reform Proposal recommends that the statutory and regulatory regimes for futures and securities be harmonized.[4] Harmonization may reduce the disparities between regulation of securities and futures, and we commend the Administration for recommending this important initiative and urge Congress to adopt it. While harmonization of the securities and futures statutes would represent a vast improvement, we believe it is only the first step -- albeit a critically necessary one -- toward ending bifurcated jurisdiction.

We have serious concerns about how much harmonization can truly occur between two separate agencies.[5] Even in the most hopeful of outcomes, with optimal harmonization of the securities and futures laws, the existence of two separate agencies, with differing philosophies, will continue to foster conflicting interpretations and enforcement of the same laws, perpetuating disjointed regulation, duplication of efforts, regulatory uncertainty, and delay.

Consolidation

While there are interim steps that can be taken to dampen some of the ill effects of divided jurisdiction, consolidation of the agencies is the only truly comprehensive solution. Any rational, unbiased, assessment of the bifurcated regulatory system would lead to this conclusion. In calling for a merger, we do not want to suggest that the securities system of regulation is preferable to the futures system, or vice versa, or that the SEC should take over the CFTC. Each

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[4] Pursuant to the Reform Proposal, the SEC and the CFTC would retain their current responsibilities and authorities as market regulators, although the Administration proposes to "harmonize the statutory and regulatory frameworks for futures and securities." In that regard, the Reform Proposal notes that "[w]hile differences exist between securities and futures markets, many differences in regulation between the markets may no longer be justified," suggesting that there are gaps and inconsistencies in the regulation of derivative instruments by these two regulators that should be rectified.

[5] For example, the securities and futures markets use very different models for clearance and settlement. The securities options markets employ a common clearing structure that facilitates the development of competing exchanges. In contrast, the futures markets use a captive clearinghouse model where a product traded on an exchange must be cleared through an affiliated clearinghouse. It is unlikely that separate securities and futures regulators could reach an agreement to harmonize these two clearing models.

system has its pluses and minuses and CBOE has, and could continue to, operate under either. What we should not continue to tolerate is the inefficient and ineffective dual structure currently in place.

Other Issues

Aside from the jurisdictional issues, we would like to touch upon several other issues discussed in the Reform Proposal. First, we agree with the Reform Proposal's recommendation that a single authority, such as the Federal Reserve Board, should supervise all firms that could pose a risk to financial stability. The events in our financial markets over the past two years underscore the need for a single body to have ultimate oversight over the broad risks in our financial system. In creating such an oversight role, however, we need to be careful not to drain away the existing and important role that the SEC, CFTC, and Treasury play in monitoring for risk issues in their respective areas.

Second, we agree with the Reform Proposal that greater regulatory oversight is needed for OTC derivatives. These products serve many useful functions, but will continue to introduce significant risks into the financial system if left unregulated. The determination of which agency should be responsible for regulation of these products will be a key issue. The split jurisdiction between the SEC and CFTC may introduce an unnecessary complication in creating efficient regulation of these products, once again highlighting the compelling need for a merger of the two agencies. In order to avoid some of the harm of split jurisdiction, the most sensible path, at a minimum, would be to vest jurisdiction over all OTC derivatives involving *securities* (including corporate events) with the SEC.[6]

Third, given the very real competitive disadvantages to securities exchanges caused by unnecessary delays in bringing a new product to market or in making adjustments to trading systems, we applaud the Proposal's recommendation that the SEC should overhaul its process for reviewing proposed rule changes by self-regulatory organizations to allow more SRO rule filings to become effective on filing.

Conclusion

CBOE believes that review of the Reform Proposal provides an opportunity to bring needed changes to the U.S. regulatory landscape in order to promote the competitiveness of U.S. financial markets. Congress should promptly adopt the

[6] Our concerns regarding the need for regulating OTC derivatives date to my testimony in April of 1997. See attached testimony.

harmonization and FSOC recommendations of the Reform Proposal, as well the proposal's call for the SEC to streamline its SRO rule approval process. Taking these steps will at least help our markets remain competitive in the global marketplace until we are able to complete a more comprehensive reform.

CBOE, WFE, and I, personally, stand ready to work with the Committee and its staff as it considers these important issues. Thank you again for the opportunity to testify at this important hearing. I would be happy to answer any questions you may have.

United States House of Representatives
Committee on Financial Services

"TRUTH IN TESTIMONY" DISCLOSURE FORM

Clause 2(g) of rule XI of the Rules of the House of Representatives and the Rules of the Committee on Financial Services require the disclosure of the following information. A copy of this form should be attached to your written testimony.

1. Name:	2. Organization or organizations you are representing:
William J. Brodsky	Chicago Board Options Exchange

3. Business Address and telephone number:
400 South LaSalle Street
Chicago, Illinois 60605

Telephone #: (312) 786-5600

4. Have you received any Federal grants or contracts (including any subgrants and subcontracts) since October 1, 2006, related to the subject on which you have been invited to testify?	5. Have any of the organizations you are representing received any Federal grants or contracts (including any subgrants and subcontracts) since October 1, 2006, related to the subject on which you have been invited to testify?
☐ Yes ☒ No	☐ Yes ☒ No

6. If you answered "yes" to either item 4 or 5, please list the source and amount of each grant or contract, and indicate whether the recipient of such grant was you or the organization(s) you are representing. You may list additional grants or contracts on additional sheets.

7. Signature:

William J Brodsky

Please attach a copy of this form to your written testimony.

OPINION

A Real Regulatory Redundancy

By William J. Brodsky

Today marks the 20th anniversary of the 1987 crash, when the U.S. stock market dropped 22% in a single day, capping a week where it lost a third of its value. This event shocked market participants and caused the greatest crisis in confidence in the stock market in 50 years. Multiple studies were done to investigate the causes of the crash and to suggest actions to restore investor confidence in U.S. financial markets.

Today the Dow Jones Industrial Average hovers near 14,000, almost *seven times* the DJIA value at the time of the 1987 crash. Trading volume in stocks, options and financial futures on an average day dwarfs the volume that overwhelmed the markets during the crash. In many ways, the strength of our financial markets is due to improvements implemented to the infrastructure of the securities and derivatives markets as a result of the crash, as well as to the transition to electronic from manual trading.

Although improvements were made to the overall resiliency of our markets in the wake of the 1987 crash, a troubling aspect of our regulatory system persists today and continues to threaten the soundness and competitiveness of our markets: Regulation of equivalent financial instruments continues to be divided between two agencies, the Securities and Exchange Commission (SEC) and the Commodity Futures Trading Commission (CFTC).

The SEC regulates "securities," which include stocks, bonds, mutual funds and options on these instruments. The CFTC regulates "commodities," which include futures on financial instruments. As a result, options on stocks and stock indexes come under the SEC's purview and are subject to securities laws, while futures on similar instruments fall within the CFTC's area and are subject to a completely separate regulatory and statutory regime.

This structure was developed in the 1970s when the futures markets traded contracts almost exclusively on traditional commodities such as grains and metals. A separate agency sprung from the Department of Agriculture was deemed appropriate for "this specialized segment of the market."

The bifurcated system was already outmoded when the market crashed in 1987. At that time, the "commodities" futures markets were already trading contracts on a variety of financial instruments, including stock indexes, foreign currency and government securities. The quaint divide between commodities and securities no longer held up. Indeed, the presidential study of the crash, the Brady Report, found that the markets for stocks, options, and futures were actually one market and should come under the overarching purview of a single regulatory agency.

> Why have two agencies to govern equivalent financial products? The result is less innovation.

Fast-forward 20 years, and the problems with divided regulation have intensified. Today's CFTC-regulated "commodities" markets have become primarily markets for futures on financial instruments and options on those futures. Yet, the divided regulatory and statutory system remains intact.

This structure hampers the competitiveness of U.S. financial markets, impedes innovation and creates serious public-policy concerns. No other country uses such a structure.

For over 30 years the divided jurisdiction has created needless legal uncertainty as to the status of new financial products. Any novel derivative that hints of a futures contract must be vetted by the SEC and the CFTC as to its legal status. The result often is an interminable delay as the two agencies try to decide which has jurisdiction over the product.

For example, our exchange, the Chicago Board Options Exchange, filed a proposal in June 2005 with the SEC to trade options on exchange-traded funds that invest in gold. The proposal has gone nowhere because the SEC and CFTC are still trying to decide, more than two years later, who should regulate the product. Markets overseas do not have this problem and, as a result, often trade new derivative products long before they are available in the U.S.

The public-policy issues from the system are numerous. U.S. financial firms are subject to duplicative and disjointed oversight from separate agencies when trading virtually equivalent products. Key investor protection and market soundness provisions, such as margin levels, are handled very differently by the two agencies for similar products. Disputes arise on managing market events.

For example, when Sentinel Management Group experienced problems this summer, the SEC and the CFTC clashed in court as to how to dispose of client funds held by Sentinel. The judge in the matter asked, "Why doesn't this agency of government go over and talk to this [other] agency of the government and get your act together, for crying out loud?"

Any rational, unbiased assessment of the bifurcated regulatory system leads to the conclusion that there should be a single agency. Recently Mary Schapiro, who has served both as chairman of the CFTC and as acting chairman of the SEC, called the U.S. oversight regime a "spaghetti bowl" of regulators and questioned the sense of having two separate regulatory agencies.

Combining the SEC and CFTC into a single agency (or even creating a new agency) has been a much-needed fix for the past 20 years. The combination of the two agencies has failed to occur for one reason: congressional turf. The SEC and CFTC are overseen by different committees in Congress, none of which wants to lose jurisdiction in the event of a merger of the agencies.

It is high time to end the congressional roadblock to addressing a problem that impedes the competitiveness of our markets and compromises investor protection. Combining oversight of the two agencies under a single committee in each chamber of Congress, and allowing these committees to address this pressing need, is one way to bypass the roadblock.

In calling for a single agency, I do not seek to favor one agency over the other. I believe the Chicago Board Options Exchange could readily live under the statutory and regulatory oversight of a properly constituted federal agency. What we cannot, and should not, tolerate is being subject to the ongoing duplication, uncertainty, and delay that results from divided jurisdiction under two agencies.

The Treasury Department currently is conducting a study of the competitive issues facing U.S. financial markets and has included this issue as part of its study. I am very encouraged by this, and hope that members of Congress likewise give this issue serious consideration. It should not take another catastrophic market event to spur Washington to do the right thing.

Mr. Brodsky is chairman and CEO of the Chicago Board Options Exchange. He previously served from 1985-1997 as CEO of the Chicago Mercantile Exchange. This article was adapted from his recent testimony before the House Agricultural Committee on Risk Management.

1997 WL 188975 (F.D.C.H.)

Testimony
April 16, 1997

House of Representatives
Agriculture
Risk Management and Specialty Crops

Revision of Commodity Market Regulations

Testimony of William J. Brodsky,
Chairman and Chief Executive officer
Chicago Board Options Exchange
Regarding H.R. 467
The Commodity Exchange Act Amendments of 1997
Subcommittee on Risk Management and Specialty Crops
Committee on Agriculture
United States House of Representatives
April 16, 1997

I am William J. Brodsky, Chairman and Chief Executive Officer of the Chicago Board Options Exchange ("CDOE"). I appear today on behalf of CBOE and nine other securities self-regulatory organizations: the American Stock Exchange, the Boston Stock Exchange, the Chicago Stock Exchange, the Cincinnati Stock Exchange, the National Association of Securities Dealers, the New York Stock Exchange, the Pacific Exchange, the Philadelphia Stock Exchange and The Options Clearing Corporation.

We welcome this opportunity to provide our views on H.R. 467. Our essential message is that the Shad-Johnson Accord, codified as Section 2(a)(1)(B) of the Commodity Exchange Act ("CEA" or "Act"), is well-considered legislation. The underpinnings of the Accord are as valid - if not more so - today as when it was originally enacted. We fully agree with SEC Chairman Levitt, who has stated that any amendments that fundamentally affect Shad-Johnson "should be enacted only after the type of consultation and cooperation displayed by the Commission, the CFTC, and their oversight committees in reaching the Accord in 1982."[1] Therefore, we believe that the Commit--tee should add a savings clause in Section 102 of H.R. 467 to make certain that the proposed professional market transactions exemption does not affect Shad-Johnson.

[1] Letter dated February 12, 1997 from Arthur Levitt, Chairman, SEC, to Senator

Richard Lugar, Chairman, Senate Committee on Agriculture.

Equities are Different
The U.S. equity securities markets are unique among equity markets around the world and are a pillar of strength in our economy. The Chairman of the NYSE: has noted that: [n]o other nation has as large or as diverse a body of shareowners as the United States, with its more than 50 million individual shareholders --n addition to more than 10,000 institutional investors. The breadth of participation in the United States is a unique source of strength for the American market . . . [T]he U.S. individual investor community is immense and . . . it not only spans the nation geographically, but also spans a very broad segment of the economic spectrum.[2]

[2] NYSE Share ownership 1995, Preface by Richard A. Grasso, Chairman and Chief Executive Officer, NYSE 2(1995).

According to a recent survey by The Nasdaq Stock Market, 43% of American adults either own stock in individual companies or mutual funds. [3] Money continues to be invested in equity securities at a brisk rate. This includes money from pension funds, IRA's, 401-K's and similar sources representing much of the accumulated wealth of our nation, and the savings and financial security of our workers. Indeed, the financial well-being of the nation, both short-term and long-term, is more and more dictated by stock market movements. The stock market is a unique American strength, and the stability of this national asset is a paramount concern.

[3] A National Survey Among Stock Investors, Conducted for the Nasdaq Stock Market by Peter D. Hart Research Associates 2(1997).

The market break of 1987 made it clear that the equities and equity derivatives markets are, in fact, one interrelated market. Thus, the creation of an unregulated "shadow" market in equity derivatives and equity futures could profoundly affect the underlying cash equity securities markets. Ever since the market break, the SEC, the CFTC, the Treasury Department, and the Federal Reserve and the affected SROs have worked toward improving the self-regulatory system and coordinating regulatory activities. After great thought, and, in some cases, experimentation, a number of new measures -- such as circuit breakers, information sharing arrangements, and other emergency measures to safeguard orderly markets were developed and implemented to protect the equity securities markets from systemic risk. We would be ignoring --he lessons we have learned since 1987 if we permit the creation cf an equity derivatives market outside these market coordination measures. Their effectiveness has been proven, and Congress should not take action that could diminish that effectiveness.

The Desirable Level of Regulation
A central focus of this committee should be whether the deregulation proposed in H.R. 467 would generate unacceptable risk to the nation's equity securities markets. The current securities regulatory scheme is the result of over 60 years of development. It is a regulatory scheme that has achieved a high level of investor confidence, making the U.S. equity markets pre-eminent in the world. We believe

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that to interject new instruments - swaps and futures on individual equities and narrow-based equity securities indices -- that could fall completely outside this regimen, is unjustified, unwise, and poses a serious threat to the integrity of this nation's organized and regulated securities markets. Such a fundamental step should not be taken without a strong economic justification for doing so and sound empirical evidence showing that such a step would not adversely affect the underlying securities markets. Indeed, the SEC, in its testimony regarding S. 257, the Senate companion bill to H.R. 467, voiced its strong opposition to the proposed "professional markets" exemption in that bill. The SEC stated that such provisions: would expose futures markets to additional risk of manipulation, call into question the validity of the exchanges as price discovery mechanisms, and place undo pressure on clearing mechanisms for both professional market and retail market transactions. These provisions also would undermine the SEC's ability to regulate trading and detect fraud in the various securities underlying the futures and options to be traded in the professional markets.

Exemption for Professional Markets
Section 102 of the bill provides for an exemption from "all" provisions of the CEA--including the Shad-Johnson Accord--for transactions that "are or may be subject to th[e] Act" so long as they are between "appropriate persons" as defined in Section 4(c) of the Act. These exempt transactions would be subject only to antifraud and antimanipulation rules promulgated by the CFTC. Further, OTC transactions effected under the exemption cannot be submitted to and clearinghouse or clearing system that has not been approved by the CFTC. The proposed definition of "appropriate persons" is so broad that it has been estimated that 90% of current futures trading volume would be exempt under this provision.

We are strenuously opposed to this provision of H.R. 467 as it relates to equity-related products. While we have been informed that Section 102 is not intended to affect the status quo with regard to products covered by the Shad-Johnson Accord, this intention is not reflected in the language of the section. An attachment to our testimony suggests minor changes to Section 102--the addition of a Shad-Johnson savings clause--that would reconcile the language and intention of the provision. The issues raised by modifying or repealing the Accord, as is done in Section 102 of the bill are profound and difficult. In our view, if Congress believes that reconsideration of the Shad-Johnson Accord is necessary, it should instruct the CFTC and SEC, in --consultation with the Department of the Treasury and the Federal Reserve Board, to revisit the Shad-Johnson Accord and report any recommendations for amendments to the Accord to Congress. Any such recommendations should then be fully considered by all relevant committees of jurisdiction. Such a deliberate, careful process is preferable to affecting the Accord in the context of a general exemptive provision.

On-Exchange Transactions
Unless modified as we have suggested, Section 102 of H.R. 467 would permit exchange trading of futures on individual stocks and equity indices by "appropriate" persons virtually free of any regulation. These transactions are now prohibited by Section 2(a)(1)(B) of the CEA. We are unalterably opposed to any exemption from Shad-Johnson for new or existing products and urge you not to permit equity-based derivative products to trade on a professional exchange market. The policy concerns

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--hat led Congress to prohibit futures on individual stocks and narrow-based indices and to impose special requirements on futures on broad-based indices pursuant to the Shad-Johnson Accord in 1982 have not changed, and apply with equal force to new and existing equity-based derivative products. In our view, exemption from Shad-Johnson would entail grave risk to the underlying securities markets without providing appreciable benefits to investors.

Permitting futures on individual securities, narrow-based indices or broad-based indices to trade on a professional market could undermine securities laws to the detriment of market integrity and investor confidence. Shad-Johnson represents a careful balancing of the securities and futures regulatory structures. Yet, even in fully-regulated markets, differences between the futures and securities regulatory regimes are significant. These differences make it essential for the SEC to play a role in any decision to permit trading in these types of securities-related products, to assure coordinated regulation of all securities and related products. [4]

[4] We do not contend that the securities regulatory scheme is inherently better than the futures regulatory scheme. However, these regulatory schemes developed differently in order to address the different public policy issues posed by securities and futures.

For example, a significant number of retail investors participate in the securities markets while this is not the case in the futures markets. Our concerns are magnified by the current proposal to offer these products without any federal government oversight other than the antifraud and antimanipulation rules promulgated by the CFTC. While we are all self-regulatory organizations and believe deeply in the value of self-regulation, we do not believe that self-regulation alone is sufficient to protect our nation's securities markets. Self-regulators cannot, for example, command coordination, information sharing or appropriate action from non- members.

The professional markets exemption would permit the futures exchanges to unilaterally opt out of whatever aspects of the CEA they felt were burdensome or inconvenient. These could include intermarket circuit breakers, margin requirements, front-running rules, recordkeeping requirements and audit trail requirements. While we believe that customers would ultimately reject a market without these protections, great damage could be done to the underlying securities markets in the interim. We do not believe that the nation's securities markets should be subject to such experimentation. The nation's wealth and financial security is inexorably linked to the securities market and it would be reckless to permit unprotected experimentation in this market. H.R. 467 also creates ambiguity with respect to the requirement of Shad-Johnson that all futures on securities be traded only on a contract market that has been designated after specified findings are made by the SEC. The changes contemplated by section 103 could be interpreted as permitting a designated contract market to trade in its exempt professional market any futures contract that had been previously approved for its regulated market. Such a result would obviously be inconsistent with the intent of section 104 of the bill, which makes it clear that the expedited designation procedures are not to apply to futures contracts covered by Shad-Johnson. Further, permitting

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currently designated stock index futures to trade on a professional market would render meaningless the efforts of Congress, the SEC, CFTC, international regulators and market participants themselves to enhance intermarket coordination since the market break of 1987.

We urge the Committee to except both new and existing Shad-Johnson products from the exemption for professional markets.

OTC Transactions
The broad exemption contained in Section 102 significantly expands the exemptions for swaps and hybrid instruments promulgated by the CFTC in 1993. First, the CFTC's Part 35 exemption for swaps has been transformed into an exemption for any "agreement, contract, or transaction" if the only parties are "appropriate persons," without regard to whether they are part of a class of fungible, standardized instruments or to the creditworthiness of the parties or to whether the transaction is effected through a multilateral execution facility. Providing an open-ended regulatory exemption from the CEA for all equity-based OTC transactions puts the current regulatory system at high risk. This broad exemption has within it the seeds of great danger. Limiting the Section 102 exemption to the same instruments and the same conditions as the CFTC's Part 35 exemption would address this concern. This leads to a second, and more important concern: any product that qualifies for the Section 102 exemption would be exempt from the Shad-Johnson Accord. Those favoring such an exemption believe that this would enhance legal certainty for equity swaps and equity-based hybrids, which they could then market on a wide-scale basis. In contrast, we believe that this would likely lead to the proliferation of these products outside an appropriate regulatory scheme, thereby creating an unacceptable risk for the securities markets.

We currently know little about the breadth and scope of the equity swap market. Unlike the interest rate and currency swap markets, the equity swap market is not well developed. However, anecdotal evidence indicates that the domestic market for equity swaps is minuscule. We are not aware of any research on the potential effect of large-scale development of this market on the underlying equity securities. Therefore, there is no basis to conclude that there can be an unbridled expansion of this unregulated market without having a deleterious effect on the underlying securities market.

The reason we have little information on equity derivatives is because the market is unregulated, and the entities engaged in this business have never provided reliable or comprehensive information as to its nature and extent. Firms that belong to the Derivatives Policy Group submit some information to the SEC. [5] The SEC also can inspect firms registered with it to review data if it has cause to believe that swaps may have been involved in or contributed to a questionable movement in the securities market. This system of voluntary filings and limited accessibility is hardly comparable to the extensive intermarket surveillance agreements and early warning systems currently in place at the SEC and CFTC for exchange traded instruments. As a general matter, after-the-fact intervention is no substitute for a regulatory structure that is intended to be anticipatory, and thereby avoid creating problems in the first place.

[5] The members of the Derivatives Policy Group are: Credit Suisse First Boston; Goldman Sachs; Lehman Brothers; Merrill Lynch; Morgan Stanley; and Salomon Brothers.

We also are concerned that the proposed blanket exemption ignores the proven strong relationship between trading in equity-based derivatives and the related cash markets. The exemption could have a significant adverse effect on the cash markets. We know that there is, at best, incomplete information on the extent or nature of trading in the unregulated equity based derivative markets. We also know that this is a market in which regulators have no legal ability to: require trading reports; impose "circuit breakers," position limits, trading halts or margin requirements, if they should prove necessary; obtain the information required to monitor the markets; prevent evasion of the prohibitions and requirements of the securities laws; or mandate fair competition among participants. Thus, this is a market that could present great potential dangers for the nation's regulated securities markets. To preclude regulators from having the means to step in, if necessary, to address systemic risk is neither wise nor necessary.

We are also concerned that the antifraud rule contemplated by Section 102 may prove toothless for OTC transactions. This is because any antifraud rule promulgated by the CFTC could extend no further than --he antifraud provisions of the CEA itself. Section 4b(a) has been read by some as applying only in the context of fraud committed in the context of a broker-customer relationship. Under this interpretation, principal to principal transactions, such as equity swaps, may be outside the reach of the CEA's basic antifraud provision and any antifraud rule premised on Section 4b.

If the Committee decides that it is appropriate to clarify the legal status of equity swaps and equity hybrids under the Commodity Exchange Act, we recommend that you exclude only those particular products from the CEA, This is the approach advocated by the SEC in its Written Statement Regarding S. 257 before the Senate Committee on Agriculture, dated March 14, 1997. Such an exclusion would make clear that such products are not subject to the exclusive jurisdiction of the CFTC. Sections 103 and 104 provide simplified procedures for contract market designation. These Sections preserve the requirements and procedures of the Shad-Johnson Accord that are applicable to equity-based futures products. These requirements and procedures recognize the legitimate interest of the SEC in these products. While we support the portion of Sections 103 and 104 that maintains the viability of Section 2(a)(1)(B) of the CEA, we have no position on the general issue of whether the current contract designation procedures of the CEA should be amended.

In closing, the Shad-Johnson Accord was a carefully crafted compromise drafted by the SEC and the CFTC. If Congress feels that reconsideration of the Shad-Johnson Accord is necessary, it should instruct the CFTC and the SEC, in consultation with the Department of the Treasury and the Federal Reserve Board, to revisit the Shad-Johnson Accord and report any recommendations for changes to the Accord to Congress. We believe that this approach would help to ensure that the many profound issues raised by equity-based derivatives would be carefully considered prior to any change in the Accord. We strongly urge the Committee to add a Savings clause to Section 102 to make clear that the bill does not affect the Shad-Johnson Accord.

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Thank you for giving us the opportunity to express our views. We look forward to working with the Committee as it progresses in its consideration of H.R 467.

WILLIAM J. BRODSKY

Chairman and Chief Executive Officer

Chicago Board Options Exchange

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