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Webb, Jean A.

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SECRETARIAT

From: secretary
Sent: Friday, October 16, 1998 7:39 AM
To: Webb, Jean A.
Subject: FW: Final, Final, Update!

Reply_to_OTC_Concept_Release d...

COMMENT

COMMODITY FUTURES TRADING COMMISSION
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OCT 16 2 07 PM '98

-----Original Message-----
From: Robert Champion [mailto:rchampion@champion-sf.com]
Sent: Thursday, October 15, 1998 8:25 PM
To: secretary@cftc.gov
Subject: Final, Final, Update!

Ms. Webb:

Attached is our final (promise!) update of our response to the OTC Derivatives Concept Release. I noticed that the date headings on the pages following the first page of our letter (only) had October 14, not October 13, which was the deadline and when we first faxed our response. The date error is corrected in this file.

I also corrected a small tabbing error in a paragraph on page 5. Otherwise, everything is as we originally e-mailed to you (with the typo corrections I mentioned).

Bob Champion
Champion Securities/Champion Capital
Bob Champion E-mail: rchampion@champion-sf.com
Champion Securities Voice: 415-616-7314
San Francisco Fax: 415-788-7303

Rec.

Champion Securities

FAX

601 California Street, Suite 303
San Francisco, CA 94108

Telephone: 415-616-7314
Facsimile: 415-788-7303

Robert R. Champion

98-19
33

COMMENT

To: Jean A. Webb, Commodity Futures

From: Robert R. Champion

Date: Wednesday, October 14, 1998

Number of Pages: 9

Memo: Ms. Webb:

We found several typos in the letter we faxed you last night and have corrected them in this version. Please substitute this letter for the one you have. The exhibits and appendix are fine.

I will be e-mailing you everything as soon as this fax is complete. All of these documents were prepared using Word 6 on the Macintosh. You will not have Exhibit I, the letter from SAAFTI, nor Exhibit A-I, the exhibit in Appendix A. If needed, you will have to scan those yourself.

Sorry for the late submission!

Bob Champion

PS: If you would like page one of the letter on our letterhead, I would he happy to mail it to you.

&

Champion Securities

601 California Street, Suite 303
San Francisco, CA 94108

Telephone: 415-616-7314
Facsimile: 415-788-7303

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OFFICE OF THE SECRETARIAT

FAX

Robert R. Champion

98-19

33

COMMENT

To: Jean A. Webb, Commodity Futures
From: Robert R. Champion
Date: Tuesday, October 13, 1998
Number of Pages: 15

Memo: Ms. Webb:

Here are Champion Securities' comments regarding the Commission's "OTC Derivatives Concept Release." I also have e-mailed this material except for Exhibit I to the comment letter and App A - Exhibit I, both of which are not in a format suitable to e-mail.

I have faxed separately Exhibit I to our comments with a separate cover sheet. Please place it after the comments letter in front of Exhibit II and Appendix A. Appendix A should be the last item in our package.

I would appreciate your distributing copies of our responde to the Concept Release to the Commissioners. Thank you.

Robert R. Champion

COMMODITY FUTURES
TRADING COMMISSION
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PUBLIC RECORD

Oct 14 11 58 AM '98

&

October 13, 1998

Ms. Jean A. Webb, Secretary
Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street N.W.
Washington, DC 200581

Re: Over-the-Counter Derivatives Concept Release

Dear Ms. Webb:

Champion Securities Company LLC, a California corporation registered as a broker-dealer under the Securities Exchange Act of 1934, is the sole placement agent for a hybrid debt security issued by Champion Capital Corporation, a Delaware corporation (both firms, collectively, "Champion").

Champion's hybrid instrument, *MarketPlus*SM, is a fully-paid, asset-backed, debt obligation of Champion that can be linked positively or negatively to a "Multiple" of the total return of the S&P 500 stock index. When no linkage is specified, MarketPlus earns a money market rate of return. The Multiple can be set anywhere between +3.00 and –3.00 and can be changed easily and at low cost at any hour or half hour during the market day using a voice response computer system or, with a new instrument now under development, via the Internet.

MarketPlus was developed specifically for individual investors and registered investment advisors who cannot, or do not want to, use stock index futures contracts in managing their investment portfolios. It enables these investors and managers (who otherwise would be switching among no-load mutual funds at the market close) to manage their stock market risk/return exposure with much of the flexibility, liquidity, and cost-efficiency now available only to stock index futures traders and large institutional investors.

As a result, MarketPlus "levels the playing field" for these investors and managers and has been praised by professional money managers, academics, and individual investors. Champion believes that MarketPlus is the kind of responsible financial innovation that Congress intended to foster when it passed the *Futures Trading Practices Act of 1992* (the "1992 Act")

Champion began offering MarketPlus (then called the *MarketMultiple Account*, or "MMA") only to accredited investors, predominantly high-net-worth individuals, on January 29, 1992 under an exemption relying on the Commission's *Statutory Interpretation Concerning Certain Hybrid Instruments* (the "Interpretation"). Between January 1992 and December 31, 1997, Champion sold approximately $66 million of MMAs (sales of MMAs have been hurt by an unfavorable tax consequence of the Interpretation that affects tax-exempt holders). The total number of persons who invested over this period was 215. At any one time, the maximum value of MMAs outstanding was approximately $23 million, and the highest number of holders was 88. On December 31, 1997, the value of MMAs outstanding was $15.4

million.

In the almost seven years since January 1992, Champion has successfully administered MarketPlus in accordance with all agreements, satisfied all redemption and termination requests, and executed over 4,000 hedging trades with a notional S&P 500 index value well in excess of $15 billion. Although Champion has administered, managed, and operated MarketPlus as planned, the S&P 500 indexing decisions of some holders caused them to experience losses. Nevertheless, as of this date, Champion has not received one complaint from any holder or registered investment advisor regarding MarketPlus or Champion's operations.

In addition, Champion has been audited five times: twice by the National Association of Security Dealers ("NASD"), once by the Securities and Exchange Commission ("SEC"), and twice by the California Department of Corporations. In each audit, Champion was found to be in compliance with all applicable rules and regulations.

Champion provides this background information to establish its credentials for responding to the Commission's request for comments on its "Over-the-Counter Derivatives Concept Release" (the "Release") as it pertains to hybrid instruments, the contribution these instruments can make in the retail investor market, and the ability of federal and state security regulators—in combination with the NASD—to provide more than adequate regulatory oversight and investor protection with respect to hybrid instruments offered pursuant to a public registration statement.

General Comments

As the Commission notes in the Release's introduction, participants in the OTC derivatives market traditionally have been large financial, fiduciary, and governmental entities. In our view, however, one of the major potential new end-user groups of OTC derivatives—especially hybrid instruments—will be retail investors. In a 1991 article, financial writer Michael Shrage stated, "By the end of this decade, highly marketable off-the-rack blends of synthetic securities—options, futures, and other so called derivatives—are going to redesign the $1 trillion [now over $5 trillion] mutual fund industry in ways we can't yet anticipate."

Champion's experience in offering a hybrid instrument developed for the retail market over the past seven years has confirmed this opportunity. Exhibit I is a letter written to CFTC Chairman Mary L. Schapiro in March 1995 by the president of the *Society of Asset Allocators and Fund Timers, Inc.*, the largest trade organization of registered investment advisors who manage money primarily for retail investors using mutual fund timing. In this letter, the society's president describes how derivative securities like MarketPlus benefit their clients. Any comprehensive review of OTC derivatives regulation must take into account, and plan for, the use of hybrid instruments by individual retail investors.

A comprehensive review of OTC derivatives regulation must also address the ambiguity and legal uncertainty created by the insertion of the parenthetical "except for section 2(a)(1)(B)" in the Commission's section 4(c) exemptive authority in the Commodity Exchange Act (the "CEA"). Since Champion first initiated discussions with the Commission in 1993 about the meaning of this exception, CFTC staff members have stated that the issue was being studied and that a substantial question exists as to whether the Commission has the authority to grant exemptions to OTC derivatives that may be futures and which implicate a securities index.

Growth in the OTC derivatives market—particularly with respect to the retail investor market, where the availability of securities-linked products is essential—will be severely limited until the "2(a)(1)(B)" issue is resolved. To contribute to a timely resolution, Champion has submitted a proposed interpretation of "except for section 2(a)(1)(B)" to the Commission for consideration. In sum, this interpretation—which is attached to these comments as Appendix A—argues that swaps and hybrid instruments linked to broad-based securities indexes that have been approved for futures trading in accordance with CEA section 2(a)(1)(B) are eligible for exemption under the Part 34 or Part 35 rules. This interpretation makes sense, uses scarce regulatory resources efficiently, and meets the spirit and the intent of "except for section 2(a)(1)(B). " It also would level the playing field between the OTC and exchange-traded derivatives markets.

Regarding hybrid instruments, it is Champion's view—based on dealing with Commission staff on these issues for 10 years—that what constitutes the characteristics of a futures contract versus those of a security is too inconstant to enable financial engineers to innovate with some semblance of regulatory certainty.

For example, at one time or another, the Commission has used *leveraging* as the key distinguishing characteristic between a futures contract and a security. The Interpretation required, among other conditions, no greater than one-to-one indexing. Yet many individual securities and mutual funds have betas in excess of 1.00. And today, investors can buy "beta" mutual funds that are designed to provide up to two times the S&P 500 return, long or short, and buy them on full margin to achieve ±4.00 indexing. In order to compete with these mutual funds, Champion has had to loan holders the funds to achieve a greater than one-to-one exposure to the S&P 500. These loans are economically unnecessary and only add to the cost, complexity, and tax disadvantages of Champion's product, making it unattractive in today's retail market.

The Commission subsequently, in its "Part 34" rules, recognized that total *volatility*, not just leveraging, was the distinguishing characteristic between a futures contract and a security. Part 34's "predominance test" formalized this recognition and provides a workable methodology for determining whether a hybrid instrument is more characteristic of a futures contract or a security. Financial engineers should object strongly to any attempt by the Commission to depart from an objective measurement of "commoditiness" with respect to hybrid instruments.

As suggested below, however, the Commission should require the predominance test to be calculated not only "as of the time of issuance of the hybrid instrument," as stated in Part 34, but also *anytime an exempted instrument is repriced.* This interpretation will enable hybrid instruments that can be dynamically repriced, such as MarketPlus, to be exempt under Part 34 without requiring them to be terminated and reissued (incurring unnecessary cost) in order to change indexing.

The Release's discussion of Part 34 expresses a belief that an instrument that can accrue losses in excess of its face value is "more akin to a position in a commodity derivative than to a debt, equity, or depository instrument." But an investor who shorts a security can lose more than the price of the security, and no one would argue that this possibility makes the initial transaction one that is taking place in a commodity.

Lastly, in examining its regulatory approach to hybrid instruments, it is important that the Commission keep in mind that—unlike swaps—hybrid instruments that are exempt under Part 34 will have significant regulatory oversight by the SEC, state securities regulators, and the NASD. The credit-worthiness of an issuer and the riskiness of an instrument will be fully disclosed with, in the case of a public offering, suitability requirements established by the most stringent state regulator.

Answers to Specific Questions and
Issues Regarding Hybrid Instruments

In its introduction to the request for comments regarding hybrid instruments, the Commission raises the following issues, which are followed by Champion's response:

y The definition of a hybrid instrument under Part 34 is "extremely complex and difficult to understand and to apply." If a potential issuer of a hybrid instrument is confused by Part 34, we would argue that they should not undertake the transaction until they do understand the logic behind, and application of, the rules.

y "Moreover, the Commission staff has recently reviewed several hybrid instruments that had *very significant commodity components* [emphasis added] yet were apparently eligible for exemption under Part 34's technical definition." If those instruments met Part 34's predominance test, then by what other standard did Commission staff determine that the instruments had a "very significant" commodity component? If it were some kind of subjective CFTC "feel test," then that can only result in an unacceptable level of legal uncertainty in the OTC derivatives market.

y How can principal be "commodity independent" if it can be lost as a direct result of movement in a commodity index? The Release contains disconcerting language affecting hybrid instrument exemptions under either the Interpretation or Part 34. The language suggests new-found concern over hybrids whose commodity-independent components (i.e., principal and/or coupon payments) are potentially at risk due to an adverse commodity price movement. Economically, this outcome could arise in any hybrid instrument having an embedded (long or short) forward-like feature or embedded short option.

Since 1989, the Commission has defined a hybrid instrument as one that combines characteristics of securities or bank deposits with characteristics of futures or options. The language referenced above seems to imply that hybrids where the holder can get more than principal and interest back (such as from an imbedded call option) are, under certain conditions, not commodity-like, but ones where the holder may get less than full principal and interest back (such as with an imbedded forward contract) are commodity-like.

But the logical extension of this viewpoint is that the Treasury bills an investor buys in conjunction with a futures contract (such as in replicating an S&P 500 basket purchase) are commodity-dependent since the investor may have to use some of the proceeds from sale of the bills to pay off a loss on the futures contract. Such an interpretation would seem to raise a myriad of unusual issues regarding both securities and tax law that are not necessary.

Any movement by the Commission to restrict the design of hybrid instruments to only those where more, not less, than full principal and interest can be returned will have a devastating effect on financial innovation and the OTC derivatives market. The ability of financial engineers to design products in precisely the way about which the Commission now expresses concern was explicitly acknowledged and applauded by Congress with the passage of the 1992 Act. The Part 34 rules provide potential issuers of hybrid instruments with a "bright-line" test that gives guidance and regulatory certainty for designing innovative instruments. Such instruments provide issuers with a means to raise capital in ways that better fit the risk profile of both the issuer and its holders at a lower cost than do more traditional debt instruments.

y "[T]he technical knowledge needed to identify the commodity-dependent volatility may be a challenge for some market participants." If a market participant is "volatility-identification challenged," then Champion suggests they are not a suitable issuer of a Part 34-exempted hybrid instrument.

y "[T]he classification of identical hybrid instruments issued on different dates might be different." If relative volatility is to be the distinguishing characteristic between a futures contract and a security, then the classification of an instrument could change as a result of changes in market volatility. This inconsistency is worth the much larger benefit of having an objective measure of "commoditiness."

y "[S]hort -term instruments are more likely to be classified as exempt than long-term instruments even though short-term instruments generally are more akin to exchange-traded futures in many respects." The market recognizes that a holder of a short-term instrument is less likely to experience the full range of volatility than the holder of a longer-term instrument, where the likelihood of a large loss is greater. With relative volatility the distinguishing characteristic, having less exposure to volatility is less commodity-like than having more exposure.

y "[T]he Commission could exercise its authority under Section 4(c) to exempt some or all of such instruments…[those found to be predominantly futures contracts]." The Commission has shown no willingness since the granting of its section 4(c) exemptive authority to grant individual exemptions. In fact, the Commission has stated that Congress has cautioned it to use its section 4(c) authority "sparingly."

y The Commission "welcomes alternative suggestions for analyzing hybrid instruments and for simplifying the definition of exempt hybrid instruments." The simplest, easiest, and cleanest definition of an exempt hybrid instrument is that it is one that the SEC determines that it can adequately regulate and provide holder safeguards for. It should not be necessary, as has been the case with MarketPlus, for the SEC to need the CFTC to "sign-off" on an instrument that the SEC has determined to be a security.

The following are Champion's answers to selected enumerated questions in the Release:

17. "In what ways has the hybrid instrument market changed since the Commission adopted Part 34?" As stated earlier, and as illustrated in Exhibit II, hybrid instruments have now evolved to where the relationship between the commodity-independent and commodity-dependent components can be varied during the term of the instrument. On the other hand, the regulatory uncertainty caused by "except for section 2(a)(1)(B)" and the costliness of applying the predominance test to modern hybrid instruments such as MarketPlus has severely limited financial innovation.

"The mechanics of execution:" Computer and communication advances have made it possible to offer hybrid instruments to a larger number of suitable holders using interactive voice-response systems and the Internet.

"The methods for securing obligations:" In Champion's case, a trustee representing all MarketPlus holders holds a perfected security interest in Champion's hedging account assets along with a letter of credit such that Champion always maintains no less than 104% liquid asset backing supporting its obligations to holders. This "credit support" arrangement is fully disclosed to potential holders. Those who are not comfortable with it will not buy the instrument.

"The impact of the current regulatory structure:" As described earlier, as a result of the legal uncertainty surrounding securities-linked instruments and the inconstant nature of the Commission's decisions regarding hybrid instruments, the current regulatory environment does not foster financial innovation.

19. Hybrid instruments do not serve a price discovery function. On the other hand, they enhance price discovery on the futures exchanges by bringing transactions to the floor that otherwise would be implemented (less efficiently) some other way.

20. MarketPlus holders who cannot or do not want to use futures contracts use Champion's instrument to hedge positions in a stock portfolio or in mutual funds.

21. Champion sees no way that a hybrid instrument could be used to manipulate commodity prices.

24. The Part 34 rules currently place significant quantitative restrictions on the amount of commodity indexing that may be built into a hybrid instrument. And, the maximum loss provision protects an investor from having to make subsequent out-of-pocket payments during the life of the instrument due to commodity price movements, a characteristic of futures contracts.

In Champion's view—based on almost seven years of offering a hybrid instrument to retail investors under an exemption much more confusing, costly, and complex than would be the case under Part 34—the Part 34 rules do provide reasonable, objective criteria for determining whether a hybrid instrument performs the functions of a futures contract or those of a security or depository instrument and market participants understand and can apply the criteria.

As suggested earlier, however, Part 34 does not explicitly address hybrid instruments where the relationship between the commodity-independent and commodity-dependent components can be varied during the term of the instrument. This innovation can be accommodated in Part 34 by interpreting "calculated as of the time of issuance of the hybrid instrument" to include "or anytime the instrument is repriced."

The Commission, in fact, made this interpretation in adopting the original Part 34 rules in 1989 when it confirmed that "the relevant time for making the…implied option premium calculation is when the instrument is *priced* [emphasis added]." The Commission further stated that, in the case of instruments offered on a continuous basis (as MarketPlus is) but frequently repriced based upon market conditions, "the premium test should be met each time firm prices are fixed."

25. The most significant steps the Commission can take to promote greater legal certainty in the hybrid instrument market would be to:

(1) Interpret "except for section 2(a)(1)(B)" as Champion proposes;

(2) Leave Part 34 and the predominance test alone but, as described above, interpret "at issuance" to include "at pricing";
(3) Have a commitment to greater regulatory continuity and "institutional memory." Otherwise, financial engineers will not have the regulatory certainty they need to peruse costly and time-consuming innovations;
(4) Work with Congress and the SEC to pursue exempting hybrids that qualify under Part 34 from state security regulation. It has been Champion's experience that most state regulators are ill-equipped to evaluate and set suitability standards for OTC derivatives.
(5) Work with the SEC to devise a way that SEC registration fees on exempted hybrid instruments that are continuously offered and redeemed, as MarketPlus is, will be based on netting sales and redemptions, as now is the case with mutual funds.

26. Part 34 does not need to be amended to simplify the predominance test.

27. Champion has made a number of recommendations that, if implemented, would attract a significant number of new end-users to hybrid instruments.

28. The Commission should exercise its authority to exempt hybrid instruments that are predominantly futures contracts subject to specified terms and conditions. Doing so will foster financial innovation and allow for creative new products that straddle the traditional definitions of what constitutes a security or a futures contract. It was Champion's experience, however, that when faced with the exemptions from commodity law necessary to allow such an instrument to be marketed, the Commission determined that such exemptions would not be in the public interest.

31. and 32. The eligibility requirement for hybrid instruments specified in Part 34 is adequate, that is, that the instrument must be sold to persons permitted to own it under federal or state securities or banking laws. It has been Champion's experience that the suitability requirements set by state regulators far exceed those required of retail investors in any publicly-available security or futures contract, where leveraging can be as high as 25-to-1 in an S&P 500 futures contract with no limitation on maximum loss.

If the Commission were to establish a way in which hybrid instruments with a predominant commodity component could be offered, eligible participants should be the same as those allowed to trade futures contracts, with the market determining whether the credit behind the hybrid is acceptable.

It would be overly restrictive to attempt to have a single, all-encompassing, definition of sophisticated investor. Wealth should not be given priority over education and investment management experience in setting suitability requirements.

46. Since a hybrid instrument exempted under Part 34 will be subject to federal and state securities laws and, in most cases, to regulation by the NASD, no additional layer of regulation by the CFTC is necessary.

Lastly, regarding "Sales Practices"—at least with respect to hybrid instruments exempted under the Interpretation or Part 34—no additional requirements are necessary beyond those already imposed by federal and state securities laws and the NASD. In fact, it has been Champion's position since conceiving of MarketPlus, that since it is designed to be a retail

1 - M. Shrage, "'Synthetic' Investments on the Way!," (1991), Los Angeles Times Syndicate.

Exhibit II
Evolution of Hybrid Instruments: From "REALS" to MarketPlus

Example	Indexed				Commodity Component				Exempted From CEA Under
	Coupon	Principal	Variable Principal	Leverage	Option-Like	Future-Like	Fixed	Variable	
Standard Oil Note	✓			< 1-to-1	✓		✓		Old Part 34
REALS	✓			1-to-1	✓		✓		Old Part 34
S&P-Indexed CD	✓			≤1-to1	✓		✓		Statutory Interp
PERLS/Rev. PERLS		✓		1-to-1		✓	✓		Statutory Interp
GSCI-linked Notes			✓	1-to-1		✓	✓		Statutory Interp
Champion MktPlus			✓	≤ 1-to-1		✓		✓	Statutory Interp
Leveraged hybrids		✓		> 1-to-1		✓	✓		New Part 34
Lev/Variable prin			✓	>1-to-1		✓	✓		New Part 34
Champion MktPlus			✓	>1-to-1		✓		✓	Should be Part 34

Appendix A

Interpreting "...except for section 2(a)(1)(B)"

Section 4(c) of the Act authorizes the CFTC to grant exemptions for any instrument — including a pure futures contract — from section 4(a), the designated contract market requirement. Section 4(c) further authorizes the Commission to exempt instruments "from any other provision of [the] Act (except section 2(a)(1)(B))...." The parenthetical in the statute is referred to in the Committee Report as "the so-called Johnson-Shad jurisdictional accord." (Congressional Record, October 2, 1992, H10935.) The Conferees later say that the exemptive provision is to provide flexibility for the Commission to provide legal certainty to novel instruments where the determination as to jurisdiction is not straightforward. (Id., H10937.)

In 1982, when Congress first codified the jurisdictional accord, the House Committee Report stated that:

> "It is the hope that the jurisdictional accord will turn the focus of debate from the issue of which agency has or should have jurisdiction [over] the merits of the proposals made to the agencies. This resolution should serve the public interest, in general, and business, commerce and investment, in particular, by removing impediments to useful new instruments so that in meritorious cases their benefits could be made available without undue delay." (H.R. Rep No. 565(I), 97th Cong., 2d Sess. 39–40 (1982).)

It is apparent from this background that the parenthetical is intended to preserve the jurisdictional prerogatives of both agencies and not to preclude any type of instrument, except for futures on individual securities and certain security indexes. Nor should the parenthetical be thought of as introducing any new measure of legal uncertainty because that would be directly contrary to the statutory language and its underlying purposes.

Any interpretation of section 2(a)(1)(B) that would appear to require that hybrid instruments linked to a security index, even hybrids that are predominantly securities, be traded on a designated contract market would create a jurisdictional anomaly. Such could not be the case in any event, however, since the only section of the Act that requires futures trading on a designated contract market, section 4(a), is singled out as a section from which the CFTC is specifically permitted to grant exemptions.

Section 2(a)(1)(B) specifically divides jurisdiction over exchange-traded equity derivative transactions between the SEC and the CFTC and establishes that futures contracts on individual securities and certain securities indexes are illegal. Clause (i) of section 2(a)(1)(B) gives the SEC exclusive jurisdiction over options on one or more securities, including any group or index of such securities, or any interest therein or based upon the value thereof (an "Index").

Clause (ii) of section 2(a)(1)(B) gives the CFTC exclusive jurisdiction over contracts of sale (or options on such contracts) for future delivery of an Index (collectively, a "Contract") and, with respect to a Contract for which a board of trade is seeking contract market designation, sets out three minimum requirements (two of which are specific to the Contract and one to the Index) that must be met before the CFTC can grant contract market designation. Clauses (iii) and (iv) apply only when contract market designation is being sought for a Contract and provide, respectively, for public comment and SEC approval as to whether the Contract meets the minimum requirements in clause (ii).

A Broader Interpretation
Of "Contract Market Designation"

When section 2(a)(1)(B) was drafted, the only legal way for a board of trade to provide a futures contract for trading was by being designated a contract market in that contract. As a result, a literal interpretation of clauses (ii), (iii), and (iv) of section 2(a)(1)(B) is that these clauses do not apply to a Contract where — as now permitted under section 4(c)(1) — a board of trade is requesting an exemption from the contract market designation requirement.

This literal interpretation of section 2(a)(1)(B) would mean that a Contract proposed by a board of trade that was requesting an exemption from the contract market designation requirement would not have to satisfy the minimum requirements in clause (ii), and that the public and the SEC need not be consulted — a result almost certainly not intended by the parenthetical "except for section 2(a)(1)(B)" in the section 4(c)(1) authority.

A better and more encompassing interpretation, and one that is both logical and consistent with the intent of the jurisdictional accord, is that clauses (ii), (iii), and (iv) apply both to a board of trade seeking contract market designation and to one that is seeking an exemption from the contract market designation requirement. In other words, section 2(a)(1)(B) applies to any board of trade seeking regulatory approval of a Contract. Accordingly, in the remaining discussion, the phrase "seeking regulatory approval of a Contract" will be used to cover both of these situations.

A Reasonable Interpretation
of "Board of Trade" in 2(a)(1)(B)

A potential issuer of a hybrid instrument exempted under Part 34 (where the instrument is not predominantly a futures contract) or a participant in a swap agreement exempted under Part 35 (both, an "Exempt Party") reasonably could be viewed as not someone "engaged in the business of buying or selling any commodity…." (See CEA section 1a(1).) If an Exempt Party is not a board of trade, then the minimum requirements of clause (ii) and clauses (iii) and (iv) do not apply because they deal specifically with the conditions that must be satisfied before the Commission can grant a board of trade regulatory approval of a new Contract. (As will be shown later, however, minimum requirement (III) of clause (ii) is implicated by clause (v).)

On the other hand, if the Commission considers an Exempt Party to be a board of trade, then — in each case — the Commission would need to determine that the Exempt Party's instrument (hybrid or swap) meets minimum requirements (I), (II), and (III) of clause (ii) of section 2(a)(1)(B), and clauses (iii) and (iv) would require that the Commission obtain public comment and SEC approval.

Champion thinks that, in the spirit of the Accord, the Commission is not required to view an Exempt Party as a board of trade, and that this interpretation would not in any way narrow or restrict the definition of "board of trade." In addition, this interpretation avoids placing unnecessary demands on the oversight resources of both the Commission and the SEC. As discussed in the next section, clause (v) of section 2(a)(1)(B) does apply to an Exempt Party and safeguards the 2(a)(1)(B) prerogatives of both agencies.

Interpreting Clause (v)
Of Section 2(a)(1)(B)

By referring to "no person," clause (v) applies to anyone — including an Exempt Party — planning to offer or enter into a contract of sale (or option on such contract) for future delivery of any security, or interest therein or based on the value thereof. Clause (v) prohibits such contracts on any security, or interest therein, except an exempted security (as defined), or except as provided in clause (ii), any Index.

The second exception can be reasonably interpreted in two ways. One interpretation is that a contract on a security is permissible as long as the security is *in an Index* that complies with clause (ii). The other interpretation is that a contract on a security is permissible as long as *the contract* complies with clause (ii).

Under the first interpretation, the only applicable provision of clause (ii) that deals with an Index is minimum requirement (III), which sets forth the characteristics of an acceptably broad-based index. Minimum requirements (I) and (II) set forth the requirements that a Contract must meet in order for a board of trade to receive regulatory approval for the Contract.

The other interpretation of clause (v) requires that a Contract on an Index meet all the requirements of 2(a)(1)(B)(ii). Thus, it should be the subject of a request for contract market designation, be cash settled, not be susceptible to price manipulation or being used to cause price manipulation, and be based upon a broad-based index. This interpretation of clause (v) could also be read to prohibit any "person" other than a board of trade applying for contract market designation from seeking or even being eligible for an exemption under 4(c)(1).

But, hybrid instruments or swaps that implicate clause (v) and which seek a Part 34 or 35 exemption will, by definition, be linked to an Index. Thus, they will be cash-settled and, since these instruments serve no price discovery function, their "price" cannot be manipulated. Moreover, inasmuch as either interpretation of clause (v) requires that the Index to which a hybrid or swap is linked be broad-based, these instruments cannot be used to manipulate the price of the Index. Lastly, requiring a person seeking an exemption under Part 34 or Part 35 to be a board of trade seeking contract market designation is nonsensical since one of the main purposes of the 4(c)(1) exemption and the Part 34 and Part 35 rules was to permit instruments that are not required to be offered by a board of trade subject to contract market designation.

Accordingly, the most logical interpretation of clause (v) with respect to an Exempt Party is that it requires the Commission to expressly find that the Index comprising the commodity-dependent component of the hybrid instrument, or that is the subject of the swap agreement, meets the requirements set forth in 2(a)(1)(B)(ii)(III). Any other person, including a board of trade, seeking a section 4(c)(1) exemption would have to demonstrate, and the Commission expressly find, that the Contract or instrument met all the minimum requirements of clause (ii).

Implications for Part 34, Part 35,
And Other Section 4(c)(1) Exemptions

Under this interpretation (please see Exhibit II) of the intent of "except for section 2(a)(1)(B)" in section 4(c)(1), because an Exempt Party is not a board of trade seeking regulatory approval for a new Contract, all that is necessary to comply with section 2(a)(1)(B) is for the Commission to determine that the Index used in the instrument meets the minimum requirements set forth in 2(a)(1)(B)(ii)(III). No public comment or SEC concurrence is required.[1]

Inasmuch as the CFTC already has made this determination for indexes on which futures contracts currently trade, a hybrid instrument or swap that involves an approved index — and which otherwise meets the terms and conditions of Part 34 or Part 35 respectively — automatically is exempt from all provisions of the Act (except in the case of Part 35, the Act's anti-fraud and anti-manipulation provisions). If a hybrid or swap involves a securities index that has not been approved for futures trading, then the Commission must determine that 2(a)(1)(B)(ii)(III) is satisfied before an Exempt Party can rely on a Part 34 or Part 35 exemption.

In sum, this interpretation means that the SEC will not be involved in exempting securities-linked hybrids or swaps under the Part 34 or Part 35 rules — which currently is the situation with hybrids and swaps that do not implicate section 2(a)1)(B), such as ones linked to gold or oil. The securities or banking laws already cover these hybrids, and — importantly — the Part 35 swap exemption retains the Act's anti-fraud and anti-manipulation provisions.

On the other hand, when a board of trade requests a 4(c)(1) exemption — independent of whether contract market designation is being sought or an exemption from the contract market designation requirement is being requested — the minimum requirements in clause (ii) of section 2(a)(1)(B) must be met, and clauses (iii) and (iv) require public comment and SEC approval before the instrument can be listed or offered.

Implication of This Interpretation Of "Except Section 2(a)(1)(B)"

This interpretation of section 2(a)(1)(B) does not create a presumption that a particular instrument is or is not a security and ensures that section 2(a)(1)(B) will operate as intended, specifically: (1) allowing for financial innovation under appropriate standards and safeguards; (2) preventing futures and exempted hybrids or swaps on individual securities and narrowly based indexes; and, (3) enabling the SEC to safeguard securities markets from instruments that could be used in furthering manipulative activity.

Importantly, hybrids and swaps that implicate section 2(a)(1)(B) and which involve an "approved" security index can be issued automatically under Part 34 or Part 35 without having to involve Commission or SEC staff. This solution will provide much-needed legal certainty to an important group of innovative derivative products.

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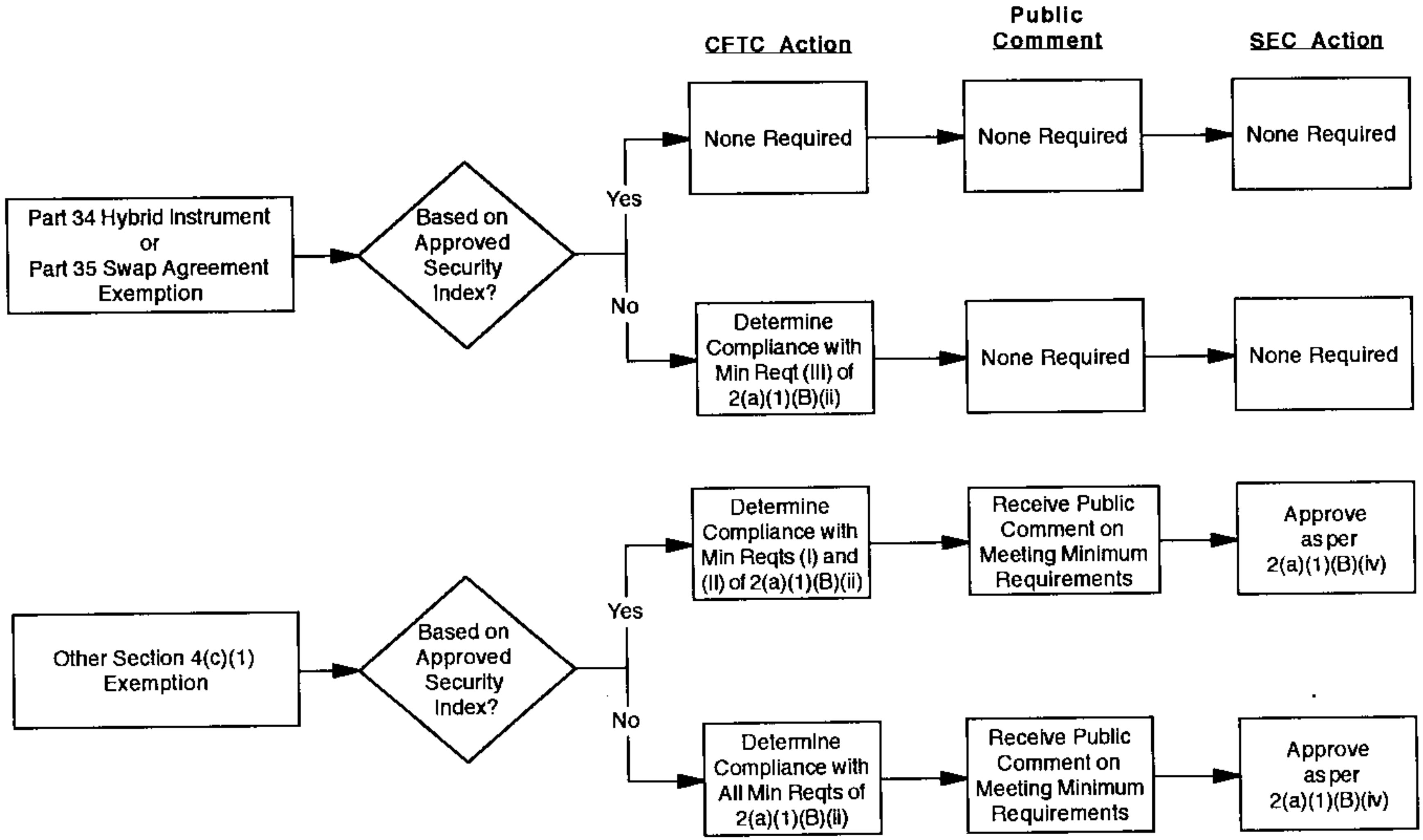
[1] If the instrument is a security, it already will be under the SEC's jurisdiction.

Appendix A – Exhibit I
Exempting Instruments That Implicate Section 2(a)(1)(B) of the Commodity Exchange Act



FAX

To:
Jean A. Webb, Secretary
CFTC
Fax: 202-418-5521

From: Bob Champion

Date: October 13, 1998 7:47 PM

Pages: 1 of 3

This is Exhibit I to Champion Securities response to the Commission's OTC Derivatives Concept Release. Please include it in our package immediately after the comments letter in front of Exhibit II and Appendix A.

Robert R. Champion

Champion Securities Company LLC **601 California #303** **San Francisco 94108**
Direct 415/616-7314 **FAX 415/788-7303**

Exhibit I

SAAFTI
SOCIETY OF ASSET ALLOCATORS AND FUND TIMERS, INCORPORATED

March 8, 1995

The Honorable Mary L. Schapiro
Commodity Futures Trading Commission
2033 K Street, N.W. Suite 800
Washington, DC 20581

Dear Chairman Schapiro:

I am writing on behalf of the *Society of Asset Allocators and Fund Timers, Inc.* (SAAFTI) to go on record as supporting the *MarketPlus* investment product developed by Champion Securities.

SAAFTI, a non-profit association, is a peer group for registered investment advisers who actively manage client assets through the use of mutual funds and market timing, dynamic asset allocation, and tactical asset allocation. Formed in 1989, our association includes over 150 member firms nationwide, managing more than $10 billion. SAAFTI's purpose is threefold: (1) develop programs to advance a better understanding by the public of dynamic asset allocation, fund timing, market timing, and other risk management strategies; (2) share ideas on marketing and back office procedures; and, (3) more effectively interface with investment companies and regulatory agencies. In addition to periodic newsletters and an active electronic bulletin board, we hold semi-annual conferences for our members and sponsors, the next of which will be held May 3-5 in Washington, D.C.

Almost all SAAFTI members rely on mutual funds as their primary investment vehicle for implementing portfolio trading strategies for their clients. Unfortunately, many of our members find that the trading and size limitations imposed on them by most mutual funds prevent their fully implementing their preferred risk management strategies. Moreover, actively trading mutual funds often results in excessive back office costs both for the advisor and the mutual fund, costs that ultimately are passed on in one form or another to clients.

Although financial futures contracts would be a more effective and less costly trading vehicle, the notional value of even the smallest stock index contract is too large to accommodate the risk/return preferences we typically implement for a client (only 13% of our clients have accounts over $100,000). And while SPDRs do enable a more precise market exposure, their transaction costs are too high for our more active adviser-members.

Because of the various shortcomings of existing portfolio trading vehicles, Champion Securities has worked for the last six years with a number of our members to design an alternative instrument, one tailored not only to our requirements but also to those of the average small portfolio trader. *MarketPlus* is the result of this effort. It makes the low cost and many of the benefits of modern institutional index trading technology available to the average retail investor—our customer. Many of our members believe that this innovative new financial instrument will provide them with risk management capabilities that are unavailable through mutual fund timing.

SAAFTI strongly supports Champion's effort to introduce *MarketPlus*. We are excited about the potential cost savings and enhanced functionality that this new product will make available to our members. Importantly, we believe that *MarketPlus* offers the potential to produce better results for our clients.

Please receive this letter from SAAFTI's board as a strong vote of confidence in Champion and *MarketPlus*, an assertion that *MarketPlus* serves a valid public interest, and as a request that the CFTC grant whatever regulatory exemptions are necessary to allow *MarketPlus* to be brought quickly to the financial marketplace—where it can compete head-to-head with other financial instruments on its merit.

Respectfully submitted,

Joseph B. Ludwig

Joseph B. Ludwig
SAAFTI President

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