

EXPERT ANALYSIS

No Sign Any Jurisdictional 'Battle' Looms on Dividend Index Futures

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In mid-November, the Chicago Mercantile Exchange will make available for trading a recently approved futures contract called the Index Contract on the S&P 500 Dividend Index.¹

The CME is promoting the Index Contract as an "innovative new way to express views on S&P 500 dividend exposure."

The Commodity Futures Trading Commission issued an approval order for the Index Contract on July 22, finding the Dividend Index to be an excluded commodity under the Commodity Exchange Act. As a result, it deemed the Index Contract a futures contract on an excluded commodity subject to the CFTC's exclusive jurisdiction.²

As described in the CFTC's approval order, the Dividend Index underlying the Index Contract:

represents the accrued ex-dividend amounts associated with all the constituent companies of the S&P 500 cumulated over the course of a specified quarterly accrual period. The [Dividend] Index ... at any given point represents a running total of dividends, through their ex-dividend dates, associated with all stocks in the S&P 500. It is calculated through a bottom-up approach whereby a running total of the dividends paid by S&P 500 constituent companies during the quarter is continuously calculated.³

A recent article by Morgan Lewis attorneys predicts a "jurisdictional battle" between the CFTC and the Securities and Exchange Commission over the Index Contract.⁴

The article questions the CFTC's characterization of the Index Contract, pointing to a comment letter filed by SEC staff. It says the letter raised "'substantial' legal and policy concerns over whether the [Index Contract] should be instead categorized as a security future subject to the joint jurisdiction of both agencies."⁵

The article further said market participants who transact in the Index Contract under the CFTC's jurisdictional umbrella may find themselves at risk of an SEC enforcement action for alleged violations of the federal securities laws.

But the article mischaracterizes both the nature of the jurisdictional question at issue and the implications of the CFTC's approval order, contrary to explicit statutory provisions and well-settled case law on the scope of the CFTC's exclusive jurisdiction.

For the reasons explained below, market participants should not be deterred from transacting in the Index Contract based on the article's warnings.

BACKGROUND

In its approval order, the CFTC found that "the Dividend Index is an excluded commodity (that is not a security or security index) ... because it is an 'economic or commercial index based on ...

values or levels that are not within the control of any party to the relevant contract, agreement, or transaction,' or, in the alternative, is an 'occurrence, extent of an occurrence, or contingency ... that is beyond the control of the parties to the relevant contract, agreement, or transaction and is associated with a financial, commercial, or economic consequence.'"⁶

As a result, the CFTC concluded, "pursuant to CEA section 2(a)(1)(A), the CFTC has *exclusive jurisdiction* over the Index Contract."⁷

IMPLICATIONS OF CFTC EXCLUSIVE JURISDICTION

More than 40 years ago, Congress vested the CFTC with exclusive jurisdiction over transactions involving futures contracts. The principle of exclusive jurisdiction has become a bedrock of CEA jurisprudence ever since.

Courts have routinely recognized that "CEA Section 2(a)(1)(A) vests the CFTC with jurisdiction to the exclusion of other agencies" in order to achieve "Congress' very clear goal of centralizing oversight of futures contracts."⁸

In the past, and most often near the CFTC's inception, the SEC contested CFTC exclusive jurisdiction in various ways.

The courts, and particularly the 7th U.S. Circuit Court of Appeals, uniformly sided with the CFTC in resolving these disputes.⁹

Court decisions have made it clear that, where the CFTC has exclusive jurisdiction, it "serves to strip [other agencies] of standing to bring [a] suit."¹⁰

The Morgan Lewis article ignores the consequences of this well-established precedent.

It concedes that the CFTC's approval order and its determination of CFTC exclusive jurisdiction "exclude the SEC from having the oversight role over the Dividend Index that it would otherwise have if the Index Contract was considered a security future."¹¹

Yet in the same breath, it recites a litany of potential charges that the SEC could bring against market participants transacting in the Index Contract.¹²

It fails to connect the dots as follows: If the SEC is ousted from an "oversight role" over the Index Contract because of CFTC exclusive jurisdiction, then the SEC cannot claim jurisdiction to sue market participants who are transacting in the CFTC-approved Index Contract.

Notably, the article overlooks a second basis for CFTC exclusive jurisdiction, one recognized by the very SEC staff comment letter the article refers to as foreshadowing a jurisdictional battle.

The SEC staff comment letter acknowledged that the Index Contract would fall under CFTC exclusive jurisdiction if based on a *broad-based* security index. Indeed, it expressed a willingness to accept this jurisdictional outcome.¹³

However, the CFTC found that the Index Contract falls under its exclusive jurisdiction as a futures contract on an excluded commodity that is not a security or security index.

In either case, CFTC exclusive jurisdiction is the end result — one that SEC staff itself was amenable to — leaving the SEC with no jurisdiction to pursue claims against market participants transacting in the Index Contract.

To the extent any residual concern over regulatory uncertainty stemming from the CFTC's approval order exists, market participants should bear in mind historical precedent involving principles of administrative comity.

Several years ago, a reverse situation existed. Lacking the CFTC's "concurrence," the SEC in 2009 approved the Chicago Board Options Exchange's petition to list an option on the Dividend Index, the Index Option.

The CFTC staff took the same view then that the CFTC has taken now in approving the Index Contract — that is, the Dividend Index "may be more akin to an event contract rather than a securities index."¹⁴

A recent article by Morgan Lewis attorneys predicts a "jurisdictional battle" between the CFTC and the SEC over the Index Contract.

Nevertheless, the SEC dismissed the CFTC view in passing and approved the Index Option as an option on a security index.¹⁵

However, since the SEC's approval of the Index Option in 2009, the CFTC has not challenged the SEC or any market participant on the basis that the Index Option is actually an option on an excluded commodity and hence subject to CFTC exclusive jurisdiction.¹⁶

Rather, the two agencies have peacefully co-existed notwithstanding their differing views on product characterization.

The Morgan Lewis article offers no credible basis for suggesting that the agencies would want to engage in a jurisdictional skirmish now over the Index Contract.

The CFTC regulates futures on the Dividend Index, and the SEC regulates options on the Dividend Index. There is no need to disturb this peace and no reason to think either agency will want to break it.

CONCLUSION

The Morgan Lewis article would have market participants believe they face great regulatory uncertainty by transacting in the Index Contract.

This belief is unfounded given the CFTC's exclusive jurisdiction and the case law precedent the article ignores.

Market participants should rest assured that as long as the CFTC's approval order claiming exclusive jurisdiction over the Index Contract is in effect, the SEC is without recourse.

NOTES

¹ See News Release, CME Group, CME Group Announces the Launch of S&P 500 Dividend Index Futures (Oct. 16, 2015), <http://cmegroup.mediaroom.com/index.php?s=43&item=3668>.

² See Commodity Futures Trading Comm'n, Order Approving the Listing of the Chicago Mercantile Exchange's S&P 500 Dividend Index Futures Contract (2015), http://www.cftc.gov/groups/public/@otherif/documents/ifdocs/ProdCMEApprovalOrdrDividx_1507.pdf.

³ *Id.* at 1-2.

⁴ See Michael M. Philipp & Ignacio A. Sandoval, *CFTC/SEC jurisdictional battle heats up over dividend indices*, 21 WESTLAW J. DERIVATIVES 21 (Sept. 10, 2015).

⁵ *Id.*, citing Sec. & Exch. Comm'n, Comment Letter on Chicago Mercantile Exchange Inc. Submission of Standard and Poor's 500 Dividend Index Futures for Commission Review and Approval per Section 5(c) of the Commodity Exchange Act and Regulation §40.3 (CME Submission No. 10-195) (July 2, 2015), http://www.cftc.gov/groups/public/@otherif/documents/ifdocs/ProdCMECommentLetter_150702.pdf.

⁶ See CFTC Approval Order, *supra* note 2, at 2-3 (quoting the definition of "excluded commodity" in Commodity Exchange Act Section 1a(19)).

⁷ *Id.* at 3 (emphasis added).

⁸ See *Hunter v. FERC*, 711 F.3d 155, 158-59 (D.C. Cir. 2013) (barring the Federal Energy Regulatory Commission from bringing an enforcement action against traders for a manipulative scheme that involved futures contracts subject to the exclusive jurisdiction of the CFTC).

⁹ See *Chicago Mercantile Exch. et al. v. SEC*, 883 F.2d 537 (7th Cir. 1989) (holding that the SEC lacked jurisdiction to approve the listing of "index participation" contracts which were futures contracts subject to CFTC exclusive jurisdiction); *Bd. of Trade of the City of Chicago v. SEC*, 677 F.2d 1137 (7th Cir. 1982) (holding that the SEC lacked jurisdiction to approve rule changes that would have allowed a national securities exchange to list certain government mortgage association-backed option contracts that were subject to CFTC exclusive jurisdiction), *vacated as moot*, 459 U.S. 1026 (1982); see also *Bd. of Trade of the City of Chicago v. SEC*, 187 F.3d 713, 716 (7th Cir. 1999) (holding that the SEC could not unilaterally impose its view of the narrow-based nature of an index underlying a futures contract when "[r]egulation of the trading process [for such futures contract] belongs exclusively to the CFTC.>").

¹⁰ See *SEC v. Univest*, 405 F. Supp. 1057, 1058 (N.D. Ill. 1976) (holding that the SEC could not bring claims against private parties for trading options on futures contracts after the Commodity Futures Trading Commission Act of 1974 vested the CFTC with exclusive jurisdiction over such contracts).

Court decisions have made it clear that, where the CFTC has exclusive jurisdiction, it "serves to strip [other agencies] of standing to bring [a] suit."

¹¹ See Philipp & Sandoval, *supra* note 4, at 3.

¹² These violations are alleged to potentially include violations of: Securities Exchange Act of 1934 (Exchange Act) section 6(h)(1) for counter-parties transacting in a security futures product off of a registered (or notice registered) securities exchange; Exchange Act section 6(h)(2) for CME listing a security futures product that does not conform to listing standards approved by the SEC; Securities Act section 5 for counterparties transacting in an un-registered security that does not qualify for any exemption; and the broker-dealer registration requirement for unregistered futures commission merchants clearing a security futures product. See Philipp & Sandoval, *supra* note 4, at 4-5.

¹³ See SEC Staff Letter, *supra* note 5, at 5.

¹⁴ See Email from Julian Hammer, Assistant Gen. Counsel, CFTC to Elizabeth King, Assoc. Dir. and James L. Eastman, Chief Counsel and Assoc. Dir., Div. of Trading and Markets, Sec. & Exch. Comm'n (May 4, 2009, 17:11), <http://www.sec.gov/comments/sr-cboe-2009-022/cboe2009022-1.pdf>.

¹⁵ See Exchange Act Release No. 61136, 74 Fed. Reg. 66713 (Dec. 16, 2009). The SEC did not characterize the nature of the underlying security index as narrow- or broad-based perhaps because, either way, the SEC has jurisdiction over all options on securities or security indices. See 7 U.S.C. § 2(a)(1)(C)(i)(I).

¹⁶ As a result of the CFTC's approval order, the Dividend Index is treated as an excluded commodity that is not a security or security index for purposes of the Index Contract, while the same Dividend Index is treated as a security index for purposes of the Index Option. This difference in treatment produces an interesting result, but not because it is unprecedented for the CFTC to regulate futures on a security index while the SEC regulates options on the same index. Rather, under the analysis in the CFTC's approval order, CBOE's Index Options should be considered commodity options (*i.e.*, swaps) under the Dodd-Frank Act and subject to the CFTC's exclusive jurisdiction. See CEA §§ 1a(47)(A)(i); 2(a)(1)(A).



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