CHAIRMAN JAMES: Mr. Harris.

MR. HARRIS: Thank you very much. I'm very pleased to have the opportunity to appear before you this morning. While Professor Ruder is bold enough to offer recommendations to you as to the parallels or lessons to be taken from the securities laws, I'm not nearly as brave as he is. So I omit any recommendations. But I hope that my remarks will provide some illumination as to areas in which one might look, were one to be interested in regulatory patterns that might be applicable.

I also want to cover not only the securities areas, but the futures areas which Commissioner Leone referred to. We often confuse, I think, those people that are not actively involved in the financial markets, the securities areas with the commodities areas. But I think it's very important to clearly distinguish between them. As Professor Ruder pointed out, in the securities area one is buying something. That is, when one buys a stock or a bond or even a derivative security, one is buying an interest in something. It is an intangible interest. Nonetheless, it is an interest in something, generally referred to as an interest in the issuer, a corporation or another type of business.

In the commodities area, one is simply entering into a contract with another party. Generally that other party happens to be a clearing corporation that is an entity that facilitates the trading between participants in the markets but one's interest in that case is simply a contractual commitment to...
receive whatever the benefit of that bargain is. There is no investment. It is simply a contract. That contract indeed is not so dissimilar from the kind of contract that one has when one gambles.

When one gambles, one enters into a contract with someone that if seven turns up on a pair of dice the first time you roll, you will be paid. In the commodities area, the contract is that if a particular price is achieved with respect to a particular underlying entity, whether that's corn or United States treasury bonds or virtually anything else, electricity rates, catastrophe insurance coverage, that one will pay you the difference or you will pay that other person the difference.

Indeed the similarities between the commodities markets and gambling are so close that in the statute regulating the commodities markets there is a specific provision pre-empting state law. That provision is in the commodities law because of a concern that under state gaming statutes, commodities activities would literally fall under and be precisely covered by state provisions on gaming. So we have in this federal statute regulating the commodities industry a pre-emption of state laws to be certain that no one can outlaw that activity on the ground that it is gambling.

Now, the counterpart of that is that when contracts are permitted to be traded pursuant to this pre-emptive authority, they must be approved by a federal regulatory commission, in this case the Commodities and Exchange Commission. In order for the Commodities Futures Trading Commission to approve a contract, they must find that it has economic value. They must find that it serves some kind of an economic purpose.
That again, is out of a recognition that one could have futures trading on anything. One could have futures trading on the NBA playoffs. That hasn't been approved and it wouldn't be approved because it wouldn't meet the economic test.

But the point I want to make is simply that there is no functional difference between the nature of the contracts that are being traded in the commodities market and the nature of the contracts that could be traded or entered into in a gambling situation. Only in one case there is a federal Commission that says those contracts to be pre-empted from state law need to serve an economic purpose, they have to be valuable.

How are they valuable? They're valuable to farmers to hedge. They're valuable to financial institutions in order to hedge. They're valuable to people who want to protect their delivery. So in fact, there are key fundamental underlying values associated with commodities contracts that may not be associated with gambling contracts. The point again is that in structure, those are the same things.

Whether we're dealing with securities or these commodities, there are essentially three kinds of regulatory techniques that the SEC with respect to securities, the CFTC with respect to commodity contracts have come up with. Those three are those that Professor Ruder has indicated and I have tried to identify for you in my presentation.

The first is disclosure. And as I try to point out, disclosure in both of these markets, in the securities markets and the commodities markets, is of two types. One type is the type that Professor Ruder mentioned. That is, if you're going to sell securities or if you're going to sell a vehicle that's going
to invest in commodities, you have to tell the particular risks
of the particular product that you're selling.

But there are also other kinds of disclosures that
are used in both the securities and the commodities area. These
I've called generic disclosures. The generic disclosures are, in
the option area, they relate to this option disclosure document
again that I included here and David Ruder called your attention
to. It's a very complex lengthy document. There is also, in the
SEC area, there is a class of security that is referred to as
penny stocks. These are stocks that typically sell for less than
five dollars a share; they are not traded on a stock exchange or
in the NASDAQ market and the SEC has come up with a generic risk
disclosure statement that must be given to any person who is
about to buy such a stock. The broker must deliver this
governmentally prescribed document, and that document is in
exhibit B in my testimony.

On the futures side, anyone opening a futures
account, that is, anyone who is going to trade futures or options
on futures, that is, anyone that is going to invest in the
commodities market must be given a governmentally written,
governmentally prescribed risk disclosure statement. That
statement is included in exhibit C. And so forth and so on with
respect to other kinds of activities that one engages in. The
government in both of these areas has seen fit not only to tell
people that they must disclose risks, but has decided that it's
going to write what the disclosure is going to have to be.

Most interesting of those disclosures is the penny
stock disclosure. Let me just read part of what the government
tells a broker he must give to his customer before he can sell
the penny stocks. "Penny stocks can be very risky. You may lose your investment. Be cautious of newly issued penny stocks. Your sales person is not an impartial advisor. Do not rely on the sales person, but seek outside advice before you buy any stock."

You've got to give the investor that before you can tell him he ought to buy this junk.

Apart from disclosure, the SEC and the CFTC has said for certain people we don't think they need that kind of protection. For certain classes of people you don't have to receive all of those warnings. There are then a whole category in both the securities and commodities area of people who are exempt from certain regulatory requirements. I won't go through all of them. David Ruder has mentioned accredited investors. But on the securities side we have a whole plethora of initialed categories, qualified institutional buyers, qualified purchasers as well as accredited investors. We have similar categories on the commodities side, qualified eligible participants, qualified eligible clients, eligible slot participants. All of those people are supposedly sophisticated and therefore, exempt from these disclosure obligations.

Finally, there is this residual category that again Professor Ruder mentioned and that's suitability. That's really saying even though we've given people all the disclosure in the world or we've avoided giving them disclosure because they're purportedly so sophisticated, nevertheless there is still some responsibility on the part of those that sell these interests to people to be certain that those interests are appropriate for them or suitable. On the securities side, that's well established. It's called the suitability requirement and it's
strictly enforced. On the commodities side, there is no such
strict suitability standard. But I want to close only by quoting
from a very famous opinion of the Commodities Exchange Commission
in which they said, "in analyzing the reliance element in
traditional fraud cases," -- we can call this over-reaching or
breaching fiduciary duty -- "it has long been recognized that
people who are exceptionally gullible, superstitious, ignorant,
stupid, dimwitted or illiterate have been allowed to recover when
the defendant knew it and deliberately took advantage of it."

Thank you very much.

CHAIRMAN JAMES: Thank you, both. It was both
fascinating and very enlightening.