CADWALADER

Cabinet **News and Views**

Informed analysis for the financial services industry

DC Court Recharacterizes Futures Contracts into Security Futures

By **Peter Y. Malyshev**
Partner | Financial Regulation

By **Nikita B. Cotton**
Associate | Financial Regulation

On July 28, 2023, in *Cboe Futures Exchange, LLC v. Securities and Exchange Commission*, the United States Court of Appeals for the District of Columbia (the "Court") issued an order vacating an exemptive order granted by the Securities and Exchange Commission ("SEC") in November 2020 that provided exemptive relief to the Minneapolis Grain Exchange, Inc. ("MGEX") in respect of its listing of SPIKES Volatility Index Futures (the "SEC Exemptive Order"). This decision is remarkable in that the Court does not afford the usual regulatory deference to the SEC and further explains that substantively the SPIKES volatility product should be treated as "security futures" and not as a "futures" product essentially concluding that "futures" products afford less protection to investors than do "security futures."

In the SEC Exemptive Order, the SEC found that while SPIKES contracts fit the statutory definition of "security futures" under § 3(a)(55)(A) of the Securities Exchange Act of 1934 ("Exchange Act") and § 1a(44) of the Commodity Exchange Act ("CEA"), SPIKES contracts should be exempt from regulation as "security futures," subject to certain conditions, in order to "foster competition" as "an alternative to the only comparable incumbent volatility product in the market." The SEC Exemptive Order thus allowed SPIKES to be subject to the regulatory regime under the Commodity Futures Exchange Commission ("CFTC") applicable to "futures," as defined in the CEA.

By way of background, the SEC and the CFTC have joint jurisdiction over the regulation of "security futures." "Security futures" are thus more heavily regulated than "futures," which are regulated solely by the CFTC. Pursuant to the Exchange Act, "security futures" (as securities) are subject to, *inter alia*, listing standards, national exchange enhanced compliance, margin and disclosure requirements. The CEA regime for "futures" allows for a different margin, exchange compliance and disclosure treatment that may be considered more lenient as compared to that applicable to “security futures”; in addition, generally “futures” products are subject to a more favorable tax treatment. In 2004, the SEC and the CFTC had issued a joint order providing exemptive relief from regulation as “security futures” to contracts traded on a “similar, but not identical” (in the words of the Court) index, the Cboe Volatility Index (known as the “VIX Index”). The petitioner in this case lists “futures contracts” in the VIX Index on its exchange.

In vacating the SEC Exemptive Order, the Court found that the SEC’s exemption was “arbitrary and capricious” in that the SEC failed to adequately establish its reasoning, in either the text of the SEC Exemptive Order or in the case record, as to why SPIKES contracts should be regulated as “futures” rather than “security futures." Absent a rehearing on the matter, the Exemptive Order will be vacated as of November 1, 2023 allowing a three-month period for MGEX, relevant intermediaries and the traders to ensure compliance with SEC requirements applicable to “security futures.”