TESTIMONY OF ANNETTE L. NAZARETH

CONCERNING THE HARMONIZATION OF FUTURES AND SECURITIES REGULATION

JOINT PUBLIC MEETING OF THE CFTC AND SEC
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I am Annette L. Nazareth, a partner at the law firm of Davis Polk & Wardwell LLP. I have spent much of my professional life working in the area of market regulation. I was the director of the Division of Trading and Markets at the SEC for approximately 7 years and then served as a Commissioner of the SEC from 2005 to 2008. I was fortunate to be able to work on regulatory reforms in the options and equities markets, which I believe provide valuable insight to the task at hand. I also worked jointly with the CFTC on matters of common interest such as the implementation of the Commodity Futures Modernization Act ("CFMA") provisions relating to the regulation of security futures products.

We are here today because, in the wake of the financial crisis and amid an ambitious regulatory reform initiative, the Department of Treasury has asked your two agencies to harmonize the differences in your approaches to the regulation of the securities and financial futures markets.

This is not the first time the agencies have been instructed, in the absence of clear Congressional guidance, to reconcile the differences in your regulatory approaches. In 2000, the agencies were required under the CFMA to jointly craft rules that would apply to single stock futures, including comparable margin requirements and regulatory filing requirements. But in that same period the regulatory approaches of the two agencies continued to diverge. While the CFMA propelled the CFTC toward a more principles-based approach to the regulation of exchanges, the SEC, in the wake of Enron and Worldcom, was compelled in a Sarbanes-Oxley environment to extend its more prescriptive, rules-based approach to regulation.

This situation reminds me of the story of the boy who is continually queried as to why he cannot be more like his friend who lives next door. Though born in the same jurisdiction, the regulatory regimes for securities and futures have distinctly disparate statutory parents. Until Congress or the Administration is willing to make some difficult policy choices, the SEC and the CFTC will continue to struggle to find common ground under very different statutory mandates and regulatory philosophies. In an ideal world, Congress would reconcile the key issues legislatively and merge the agencies so that they could harmonize the innumerable differences from within. That notion has not been embraced by Congress in the recent regulatory reform effort, however. In several key areas of regulation, the differences in statutory mandate and philosophy between the agencies are profound. These differences must be recognized and reconciled before any real harmonization can be achieved. Yet harmonization is essential to maintain the efficiency of our financial markets and our competitiveness in the global arena. Today I will highlight four key areas for harmonization: Investor Protection Standards; Insider Trading Prohibitions; Customer Protection and Margining; and Fungible Products and Common Clearing.

**Investor Protection Standards**

The agencies and the statutes have long taken a different approach to customer protection. The SEC has a perennial focus on the protection of individual investors, even as participation in the securities market becomes increasingly institutional. The Commodity Exchange Act ("CEA") views futures market participants as primarily professionals, who are best protected by preserving the integrity of the futures market. These different philosophies are reflected in disparate business conduct standards applicable to securities brokers and futures commission merchants ("FCMs"), and that divergence may become even wider in the near term. For example, the Administration's regulatory reform proposals provide, among other things, that a broker-dealer's duty to its customers should be raised from the current suitability requirement to a new fiduciary standard. At the same time futures intermediaries will continue to operate under a risk disclosure construct with no fiduciary or suitability obligations (except in the case of security futures). Thus it appears that, absent a harmonization effort in this area, brokers and FCMs will continue to compete through the sale of comparable options and futures products under very different investor protection standards. Clearly, the protections afforded investors in the securities markets should apply in the financial futures markets as well.

**Insider Trading Prohibitions**

The approaches of the securities laws and the CEA diverge even on how best to preserve the integrity of the markets. One of the cornerstones of the market integrity provisions of the securities laws is the prohibition on insider trading. The CEA generally contains no such ban (other than for CFTC and market employees), largely because one of the historical functions of the futures markets was to permit hedgers to protect themselves against risks to their commodity positions based on their own knowledge of those positions. While this disparity may have made sense when most futures related to agricultural products, today the overwhelming majority of futures are financial futures. Good public policy would dictate the extension of insider trading prohibitions to the futures markets to ensure the integrity of each of the financial markets and to prevent regulatory arbitrage.

**Customer Protection and Margining**

Another key area where the securities laws and the CEA diverge is in how best to protect customers and intermediaries from excessive financial exposure to each other. The SEC and CFTC give different answers to both the question of the best means to protect customers from the failure of their broker-dealer or FCM, and the question of the appropriate margin required to protect the broker-dealer or FCM from the customer. In large part, this divergence arises because margin serves different functions in the two different systems, but at the same time provides the same economic advantage – the ability to obtain leverage in a transaction.

In the futures markets, margin guarantees the performance on the futures contract at its termination. Because contracts are typically closed out before delivery, the loss or gain will be the difference from the closeout price, which is likely to be a smaller amount than the full contract price. Also, futures margin is marked to market daily.

In contrast, securities customers must pay the full purchase price of equity securities three days after the trade, though broker-dealers often finance 50%, and over time potentially more, of the purchase price. Thus, securities margin generally involves larger financial outlays with lower leverage compared to futures margin for comparable economic positions in instruments.

Having emphasized the fundamental differences, I also want to emphasize the importance of finding a harmonic middle ground, because of the risk reduction and competitive implications of these differences. The most direct and productive way forward is focusing on a true portfolio margining system that encompasses securities, futures, and OTC derivatives.

Significant progress has been made by the SEC and CFTC in recent years to utilize portfolio margining systems. It is sometimes said that the SEC does not use a risk-based margining system. This was true at one point when the SEC employed a strategy-based approach whereby certain option spreads had lower margin requirements when they were hedged with other options on, or securities positions in, the same underlying security. The SEC's current portfolio margining approach is also sometimes criticized for not being risk-based because it stresses products in portfolios at defined points along a positive and negative market movement range for the product's underlying instrument. While the stress points are not chosen based strictly on recent experience, the SEC's portfolio margining is based on risk-sensitivities.

While the SEC and the CFTC have both employed their own successful versions of portfolio margining systems, there are key differences between them, including the correlations recognized, the multipliers applied, and the inherent flexibility to fluidly change these factors. However, these differences can, and should, be bridged.

Cross-margining across futures and securities-related investments is critical to maximizing the benefits of portfolio margining both for customers and for the U.S. markets as they compete with London and other developed financial markets abroad that utilize a cross-margining system.

Of course, other even more intractable obstacles must be overcome to achieve portfolio margining. Differences in customer protection laws stand in the way of maximizing the benefits of portfolio margining. Customer protection rules under the CEA and the CFTC rules require complete segregation of customer funds from FCMs. By contrast, the securities laws require customer funds and securities to be set aside from use by a broker-dealer where the securities are either not margined or are paid above the level that is needed for margin requirements. The securities laws otherwise are designed to allow broker-dealers to have limited rights to use customer assets to fund extensions of credit to them. Unlike futures customers, securities customers are protected against a dealer's failure through the Securities Investor Protection Corporation ("SIPC") fund.

The result of these disparate rules has been a deadlock on further progress towards implementing a portfolio margining system. There is therefore a clear need for a concerted effort towards harmonization and reconciliation of the SEC's and CFTC's regimes. The SEC and CFTC need to agree on how to amend their respective rules to allow for portfolio margining of futures and securities.

One way forward is to revise the rules to allow all positions, both securities positions and futures positions (that are not securities), to be held in a single securities portfolio margining account. Holding these investments in a securities account has distinct advantages. The use of a single account as opposed to two accounts provides the most optimal level of economic risk offsets and avoids the difficulty of having to segregate margin relating to futures positions from that relating to securities positions, a task that would be complicated by offsetting between futures and securities positions. Holding such positions in a securities account is also important because it allows broker-dealers to continue to use the securities to extend credit to customers for financing margin loans. To effectuate this "one pot" approach, however, would require amendments to both the CFTC's and SEC's rules. The CFTC's segregation rules would need to be amended to permit futures to be held in the same account as securities; and SIPC protection, either through interpretation or legislation, would need to be made available for futures positions.

**Fungible Products and Common Clearing**

Another fundamental difference in approaches between the SEC and CFTC that has broad consequences is their approach to competing markets.

Through its national market system rules, the SEC has fostered a system of multiple, highly competitive securities and options markets trading the same securities. In 1975 when Congress passed the Securities Act Amendments, it directed the SEC to facilitate a national market system for clearance and settlement of securities transactions. Congress mandated that clearing systems be interconnected and operate under uniform rules. Congress specifically found that "[t]he linking of all clearance and settlement facilities and the development of uniform standards and procedures for clearance and settlement will reduce unnecessary costs and increase the protection of investors".[1] Simply put, Congress recognized that we can use our regulatory framework to enhance competition in the securities markets.

The effect of this mandate was significant and lasting. The equities clearing agencies linked and then slowly merged to form a utility that serves all markets. The options

[1] *See* Section 17A(a)(1)(D) of the Securities Exchange Act of 1934.

markets use a common clearer that issues and clears standard options for all markets. These securities are bought and sold on different exchanges interchangeably—the term often used is "fungible"—and clear in the same clearinghouse. This permits multiple exchanges—both large and small, established players as well as new entrants— to compete head on in the same products, leading to innovation and competitive pricing. Investors are not forced to trade in a particular market in order to achieve certain margin benefits. The clearinghouse can provide all participants with the benefits of offsets, because all of the positions in a security are held in one place, resulting in reduced margin obligations for customers. Clearinghouses likewise have cross margining arrangements.

Thus the two key features that are essential to achieving this competitive result are fungibility of products and linked and coordinated, if not common, clearing.

In my view, the securities markets have a system that has demonstrated its benefits to investors by resulting in lower transactions costs, expanded choice and technological innovation. The system also has benefits from a systemic risk management point of view, as central clearinghouses are able to mitigate the risks of counterparty defaults.

These key features are lacking in the futures markets. Futures trade in a single listing environment. The exchange on which a particular contract trades controls the clearing of that contract. Even if contracts with identical terms were traded on different exchanges, they would not be fungible. Each exchange operates in a silo, with no way for a member to offset margin obligations by taking into account positions in correlated financial futures traded on different markets.

The Department of Justice, in its comments to the Treasury Department dated January 31, 2008, drew attention to the impact of vertical integration of futures exchange services and clearing on the competitiveness of the futures markets. Vertical integration of trading and clearing makes it extremely difficult for new entrants to compete with existing markets. Simply put, competition is impaired because control of the clearinghouse drives business to the dominant market.

The differences in approach to fungible products and common clearing should be a place where the agencies can agree that there is an opportunity to achieve harmonization in order to increase competition among exchanges, lower costs for investors and achieve systemic risk benefits. This is all the more imperative as Congress considers the Over-the-Counter Derivatives Market Act, which creates a structure for exchange trading and mandatory central clearing for a great majority of OTC derivatives under the futures framework and the securities framework.

**Conclusion**

In conclusion, I would like to note that we are at this historic meeting today because the CFTC and the SEC have recognized the importance of identifying conflicts in statutes and regulations with respect to similar types of financial instruments, and determining whether those differences are essential to achieve the underlying policy objectives of the agencies. Despite the differences in the enabling statutes of the two agencies, they each focus on protecting consumers, ensuring market integrity, and promoting price transparency. Thus, they provide a basis to consider how to bridge the fundamental differences in structure and outlook in the key areas of business conduct standards, insider trading, customer protection and margin and competing markets. The challenges are great and stakes are high.