Testimony of

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Joint Hearing of the
Commodity Futures Trading Commission
Securities and Exchange Commission
September 2, 2009

Harmonization: Intermediaries

I. Why Harmonize the Commodity Exchange Act and Federal Securities Laws?

- Harmonization is, of course, a step that can be taken when others, such as consolidation, may be politically beyond reach.

- Conversely, agency consolidation achieves only a limited objective -- primarily, resolution of jurisdictional conflicts -- without an integrated regulatory framework.

- If the ultimate policy objective of agency consolidation is to accomplish more than merely a tiebreaking vote on jurisdictional and related issues, consolidation requires harmonization within an integrated framework, as well as reconciliation of fundamental statutory differences.

- Achieving these objectives presents both difficult challenges but also opportunities for public and private sector efficiencies.

- Achieving these efficiencies, in turn, requires a range of decisions. Some of the more basic, for example:

    - Should futures commission merchants and securities brokers continue to be regulated as distinct registrant categories; or should we just license brokers (and dealers) and separately address the qualifications of individuals to engage in or supervise particular activities with respect to stocks, options, futures, etc . . . ?

    - Investment advisers and commodity trading advisors? Is there a reason to retain two different registrant categories?

    - We regulate investment <u>funds</u> under the Investment company Act of 1940 but pool <u>operators</u> under the CEA; and there are significant differences in the two regulatory approaches . . .

- Similar questions can be asked with other categories of registrant.

- Although the ability to resolve these and other more fundamental statutory differences, and act on the related determinations, may be beyond reach politically and otherwise, there is nonetheless a lot that can be done over the shorter term, short of these objectives.

II. Limits to Harmonization

- There are equally obvious limits to harmonization without consolidation.
  - Some rules and policies are driven by product differences – although one suspects that, on scrutiny, these are likely in the distinct minority.
  - Commenters often talk about price bias verses price neutrality; but neither product category should defy the laws of economic gravity to any greater extent than the other – certainly not as a matter of regulatory engineering.
  - On the other hand, there is no futures analogue to the capital formation and corporate governance missions of the SEC.
  - Corporate insiders similarly raise unique issues that do and should drive differences in what intermediaries under the two regimes can and cannot do with information.
- The capital markets orientation of the securities laws has driven consequential differences between the statutes.
  - Since the mid-1970s, the Securities Exchange Act of 1934 has not favored exchange trading.
  - The CEA, on the other hand, does tend to favor exchange trading and generally requires it in the case of transactions involving participants that are not "eligible contract participants".
- Pending legislation could extend this exchange trading emphasis.
- Differences in the treatment of structured products is one of the most notable consequences of these different orientations.
  - Warrants, indexed notes, passive funds that issue interests that track asset classes exemplify this.
  - There are stark differences in the two regimes with respect to closely related products:
    - A warrant on treasury yields – can be offered to retail investors in the capital markets;
    - But a warrant on a "rate" abstracted from any security may be a commodity option that cannot be offered – plain and simple cannot be offered – without relief.
  - Options on commodity ETFs raise similar issues.

- Measures should be taken to eliminate these discontinuities on a more systematic basis than the *ad hoc* steps that have been taken to date - and to permit products such as these to be offered and sold by the sales forces and through the distribution channels that make sense for the relevant product.

III. Other Objectives

- Harmonization can lead to more efficient use of resources and lower costs for registrants.

- Harmonization also presents significant opportunities for the agencies to make more efficient use of their own limited resources.

- But it is more than just cost savings:

    - As a general matter, it seems clear that we have too many disparate regulatory schemes and too many rules whose scope and meaning are clear only to experts.

    - Too many rules addressed to the same policy objectives but prescribing different requirements.

    - Different regulatory requirements necessitate different compliance and supervisory policies and procedures.

    - Different requirements, policies and procedures necessitate different systems and programming and related resources.

    - And all of these differences require large numbers of expert, highly specialized legal, compliance, supervisory and operational resources.

- All of this costs more than just money; although money is not a trivial part of the cost.

    - In many ways, this proliferation is the recipe for what we witness daily in the industry press. Day after day, firms fail in ways small and large to comply with bread and butter regulatory obligations – and more frequently than not, it is not willful. The number and complexity of rules and nuances in their interpretation– is itself the source of a serious challenge to the ability of larger firms to manage their compliance risk.

    - The reconciliation, rationalization, harmonization and reduction of disparate rules has the potential to <u>enhance</u> compliance and reduce compliance risks and costs.

    - This should also be an important administrative objective.

IV. Near-term Objectives

- The opportunities to harmonize and reconcile the securities laws and commodities without legislative changes are numerous, including among others:

- registration requirements – even at the level of registration forms and processes;
- entitlements to exemptions;
- recordkeeping requirements and formats;
- reporting, filing and notice obligations;
- capital computations;
- customer protection and order handling rules;
- customer communication rules.

- There is a lot that could be usefully done to eliminate historical differences in CFTC and SEC rules – even before wrestling the 500 pound gorillas like the national market system and clearing structure.

- In this process the temptation will be strong to achieve reconciliation by aggregating the requirements in each of the agencies' rules.
  - This temptation needs to be resisted.
  - The commissions should not limit their goals to agreeing a common set of rules where appropriate, but should also endeavor to identify harmonizing solutions that are likely to increase effective compliance - not to make it ever more challenging.
  - There is an old aphorism that the most complex solution to a problem is probably not the best one . . . . .

V. Margin

- Just a quick word on margin; everyone is aware that the statutes adopt different approaches to margin.

- Pending legislative initiatives will increase the importance of a coherent approach to margin.

- Intermediaries provide financing to their clients – it is what they do. Capital deductions exist to account for those credit exposures. The commissions and congress need to determine what their margining objectives are:
  - Is it to dampen speculative pressures at a systemic level?
  - Is it to manage credit risk at an intermediary level?

- Is it to reduce an individual trader's leverage?
- Is it a combination of these? Should position concentration inform margin requirements? Should product liquidity affect margin requirements?
- Can you balance these considerations and at the same time avoid a regime that is not too complex to administer or comply with?

- These are important issues for the commissions to consider because they currently come at the issue of margin from different perspectives.
- Needless to say, the commissions should also pursue the steps necessary to enable investors to obtain the benefits of cross product portfolio margining.

VI. Insolvency

- Finally, some necessary measures do not really fall into the category of harmonization.
- Insolvency is an example: SIPA and the CFTC's 190 rules don't really exist in mutual contemplation of each other.
- Independent of portfolio margining, there are many questions and issues that will be raised if, someday, we are confronted with the insolvency of a major dual registrant that is subject to both regimes. For example:
    - The rules governing the circumstances in which proprietary assets can become customer property when there is a shortfall are similar, but they are different in ways that could be consequential;
    - How would a shortfall be allocated across the futures and securities customer classes? We know how they are to be allocated within these classes, but not across these classes.
- Doubtless, certain issues may need, or be best solved by, legislation. Nonetheless, the commissions should evaluate what they are able to accomplish, and to formulate recommendations for legislation that may be appropriate.