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A Joint Report of the SEC and the CFTC on Harmonization of Regulation

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Executive Summary

On June 17, 2009, the Administration released a White Paper on Financial Regulatory Reform ("Treasury White Paper" or "White Paper"),[1] outlining a plan for comprehensive financial reform to set the foundation for restoring confidence in the integrity of the financial system. Noting that "[t]he broad public policy objectives of futures regulation and securities regulation are the same: protecting investors, ensuring market integrity, and promoting price transparency," the White Paper requested the U.S. Securities and Exchange Commission ("SEC") and the U.S. Commodity Futures Trading Commission ("CFTC") to identify "all existing conflicts in statutes and regulations with respect to similar types of financial instruments and either explain why those differences are essential to achieve underlying policy objectives with respect to investor protection, market integrity, and price transparency or make recommendations for changes to statutes and regulations that would eliminate the differences."[2]

The President's call prompted the agencies to hold joint meetings to hear from the public. The agencies held unprecedented joint meetings on September 2 and 3, 2009 ("September Meeting"), with the participation of all nine sitting Commissioners. Thirty panelists, consisting of members of the investor community, academics, industry experts, and market participants assisted the agencies in defining the issues of greatest concern, and explored topics ranging from exchange, markets, and clearing issues, to regulation of intermediaries and end-users, to enforcement.[3]

Since the 1930s, securities and futures have been subject to separate regulatory regimes. While both regimes seek to promote market integrity and transparency, securities markets are concerned with capital formation, which futures markets are not. The primary purpose of futures markets is to facilitate the management and transfer of risk, and involve management of positions in underlying assets of limited supply. Certain securities markets, such as securities options and other securities derivatives markets, also facilitate the transfer of risk. The unique capital formation role of certain securities markets has informed the manner in which the two regulatory regimes have developed and, in part, explain differences between the regulatory structures of the CFTC and the SEC.

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1 Financial Regulatory Reform – A New Foundation: Rebuilding Financial Supervision and Regulation (June 17, 2009) ("Treasury White Paper"), *available at* http://www.financialstability.gov/docs/regs/FinalReport_web.pdf.

2 *See id*. at 50–51.

3 Transcripts of the September Meeting are available on the agencies' websites: at the SEC, http://www.sec.gov/spotlight/harmonization.htm; and at the CFTC, http://www.cftc.gov ("Transcripts").

Because of the role of certain securities markets in capital formation, securities regulation is concerned with disclosure – including accounting standards related to such disclosure, while commodities regulation is not. For example, because futures markets for physical commodities concern regulation of instruments which reference a limited supply of an underlying asset, regulation permits imposition of position limits. Position limits in the securities markets is important for different reasons, namely to mitigate the potential for derivatives to be used to manipulate the market for underlying securities. This Report does not address all of these differences between the regulatory regimes.

Moreover, the rapid development of the market in complex financial instruments known as derivatives, large parts of which neither agency has had the authority to regulate, has created significant regulatory gaps. These gaps, which are discussed at some length in the Treasury White Paper and currently are the subject of deliberation before Congress, are also not covered in this Report.

The focus of this Report, however, is on a number of issues that emerged through the agencies' public deliberations as the matters most relevant to a reconciliation of the two agencies' statutory and regulatory schemes. Drawing on the input received from the September Meeting and others, this Report reviews and analyzes the current statutory and regulatory structure for the CFTC and the SEC in the following areas: (i) product listing and approval; (ii) exchange/clearinghouse rule changes; (iii) risk-based portfolio margining and bankruptcy/insolvency regimes; (iv) linked national market and common clearing versus separate markets and exchange-directed clearing; (v) price manipulation and insider trading; (vi) customer protection standards applicable to financial advisers; (vii) regulatory compliance by dual registrants; and (viii) cross-border regulatory matters. These subjects are not exclusive, but the ones most emphasized by the public and in the agencies' review.

The Report concludes with a series of specific recommendations for strengthening the agencies' oversight and enforcement, enhancing investor and customer protection, rendering compliance more efficient, and improving coordination and cooperation between the agencies.

Oversight of New Products. The CFTC and the SEC are governed by different approaches to reviewing and approving products. Specifically, the securities laws are premised on the notion of high quality disclosure of material information about an issuer's securities. An issuer that seeks to list on an exchange must also satisfy that exchange's listing standards, which are filed with the SEC. The SEC has the authority to ensure that listing standards are consistent with the purposes of the Securities Exchange Act of 1934 ("Securities Exchange Act"), such as market integrity, public interest, and investor protection. The CFTC, however, does not have the authority to disapprove of a product listing unless it makes an affirmative finding that a product "would violate" the Commodity Exchange Act ("CEA"). Thus, the CFTC does not have the authority to review a product for approval prior to introduction, including contracts that may otherwise be contrary to public policy (*e.g.*, gambling, terrorism). Whereas in the past, the CEA contained an "economic purpose" test to govern product approval, the statutory

test containing that provision was repealed by the Commodity Futures Modernization Act of 2000 ("CFMA"). Moreover, under the CEA, exchanges are permitted to provide "self-certification" that a product meets the requirements of the statute and CFTC regulations, which allows the product to be immediately listed. Different procedures exist under the framework of securities regulation, which provides a streamlined process for listing and trading derivative securities products.

The agencies have faced the sometimes difficult question of which agency has jurisdiction over a particular product. Some financial products have attributes that make it difficult to determine which agency has jurisdiction over them. This uncertainty at times has caused lengthy delays in bringing new products to market. The lack of legal certainty can be costly and confusing, and it can impede innovation and competition.

Public feedback on these subjects suggested the following:

- A method of reaching prompt resolution of jurisdictional disputes is needed.
- A mechanism should be developed to break deadlocks between the CFTC and the SEC over disagreements regarding jurisdiction over products.
- Self-certification procedures should have a meaningful burden for exchanges to demonstrate that a proposed product listing will comply with applicable law.
- Regulatory agencies must have the authority to choose to review contracts or products prior to listing and be able, in some instances, to disapprove of listings.

Review and Approval of Rules. There are some basic differences in the regimes under which the CFTC and SEC approve and review rule changes and amendments for exchanges, clearinghouses, and other self-regulatory organizations ("SROs"). Under the CEA's principles-based approach to oversight, applicable to exchanges and clearinghouses as established by the CFMA, in most cases, rule filings are made under self-certification procedures. Under a principles-based approach, an exchange or clearinghouse has significant discretion in the manner in which it satisfies the statutory core principles, which are less susceptible to change, given that they may only be modified by Congress. To take formal action to disapprove a self-certified rule, the CFTC must determine that a rule violates the CEA. Thus, under the principles-based approach of the CEA, the CFTC's ability to regulate exchange and clearinghouse rules is limited. Under the Securities Exchange Act, although exchanges must submit proposed rule changes to the agency, about two-thirds of proposed rule changes are effective immediately upon filing. The remaining rule changes, however, must be approved by the SEC before they are effective. All proposed rule changes are published for comment. This process allows an opportunity for the market participants, including brokers, dealers, and investors, to comment on changes to exchange and SRO rules.

- Panelists and comments have stated that the agencies' oversight of exchange and clearinghouse rules should balance the opportunity to comment with the speed provided by self-certification. Some exchanges and clearinghouses state that self-certification enables them to implement business decisions promptly. However, other exchanges and their constituents note that a prior approval process, including one that involves a comment procedure, is important because it creates legal certainty and permits regulators to exercise oversight with proper information, which is derived in part from public input on significant issues during the comment process. Other panelists encouraged looking at ways to expedite the rule approval process.

- The CFTC standard of review for rule filings, which forbids the agency from disapproving a rule unless it finds that it "would violate" the CEA, does not afford the agency sufficient authority to ensure exchange and clearinghouse compliance with the CEA, adopt to market conditions and international standards, and protect the public..

- The SEC review process for rule filings was recently modified to create set time periods for action to be taken.

Financial Responsibility: Segregation, Insolvency and Margin. There are distinct differences in the SEC's and CFTC's approaches to segregation of customer funds, insolvency and margin.

Segregation and Insolvency. Both regimes have "segregation" rules that aim to protect customers from inappropriate use of customer funds by futures commission merchants ("FCMs") and broker-dealers ("BDs"). CFTC and SEC statutory and regulatory provisions, however, contain significant differences in the specific manner in which assets are to be segregated. Under the CEA, FCMs may not commingle customer funds either with their own accounts or the accounts of customers. Generally, a BD may not commingle its securities with those of customers or pledge its customers' securities in an amount greater than what the customer owes. If a customer has an outstanding margin loan, the BD may use a limited amount of the customer's securities for financing. There is no parallel financing practice in the futures markets because futures margin is a performance bond and does not involve an extension of credit.

The regimes governing bankruptcy and insolvency are also different. For example, in the case of a BD insolvency, there is $500,000 per customer protection under the Securities Investor Protection Act ("SIPA"). By contrast, the Bankruptcy Code and CFTC regulations, by virtue of the governing segregation rules, contemplate portability of positions and funds, whereby customers may rapidly transfer their accounts from an insolvent FCM to a financially healthy FCM. SEC regulations also contemplate expeditious transfer of customer accounts through self-liquidation or a proceeding under SIPA. In general, if the books and records of the broker-dealer are in order and customer accounts are properly margined, customer accounts may be transferred to another broker-

dealer in a process known as bulk transfer. There is no insurance coverage for customer positions and funds that are held in a segregated futures account.

Setting Margin. The CFTC and SEC also approach the regulation of margin from different perspectives. Customer margin regulations for cash securities are set by the Board of Governors of the Federal Reserve System ("FRB") and SROs. In contrast to the SEC, the CFTC does not have general authority to set margin. Margin requirements for exchange-traded securities options are generally set by the exchanges and SROs. Under the CEA, clearinghouses set "clearing" margin (margin that the clearing member posts with the clearinghouse) and exchanges set customer margin (margin a customer posts with the intermediary).

In the futures markets, margin requirements are imposed to ensure that customers post a sufficient performance bond in case they fail to meet their obligations. Margin requirements for cash securities positions establish limits on the amount of credit a broker-dealer may extend to finance securities transactions. Margin requirements for cash securities and for securities options are therefore calculated using different approaches than for futures.

- Risk-based portfolio margining, *i.e.*, the ability to cross-margin related instruments in one account, was cited by many panelists at the September Meeting as a significant area for reconciling the two regulatory regimes. Portfolio margining refers to the ability to reduce the amount of margin required by the holding of one position if another position simultaneously held by the customer would offset the risk posed by the first position. Portfolio margining would release firm and customer capital to be used for other purposes.

- Portfolio margining may be attained in one of two general ways: by placing the relevant instruments in either a single securities or futures account, or in two separate accounts. Industry participants are beginning work to establish two account portfolio margining programs. However, most panelists stated that the single account model is generally preferable.

- To achieve portfolio margining under the one account model, legislative and rule changes are needed, including legislative changes to the bankruptcy/insolvency regime of the SEC by amending the SIPA to provide for insurance protection of futures positions and performance bond supporting such positions.

Markets and Clearing Systems. The securities and futures markets differ significantly in their structure. Identical, fungible securities are traded on multiple markets in the United States as part of the "national market system," which was mandated by Congress in 1975 through amendments to the federal securities laws. Under this model, exchanges compete for trading and execution services, and clearing is done through one central clearinghouse for each product type. This structure differs from the

futures markets, where individual futures contracts generally are traded on the exchange that creates the contract. Each futures exchange then "directs" clearing, that is, it selects the clearinghouse for the instruments it lists. Often, there is vertical integration where the exchange and the clearinghouse to which it directs trades have common ownership. This same structure generally holds in other areas of the world, including Europe and Asia. In the futures markets, exchanges in the United States compete with exchanges in foreign markets to offer competing products. Although product offerings in futures exchanges may be similar in terms and their functions, they are not fungible across markets and clearing organizations. In this regard, the futures markets are different from the securities options market, which use a common clearing model that serves competing exchanges.

Though the CFTC and the SEC at present do not have any recommendations concerning market linkage and clearing with regard to futures or securities, they have supported provisions for non-discriminatory access to clearing organizations for the OTC derivatives market. On the general topic of market linkage and clearing, panelists at the September Meeting articulated contrasting views, including the following:

- The "national market system" for securities has created competition between trading venues.

- To have a system in which trading venues compete, products traded across exchanges must be fungible.

- Products in the futures industry are not treated as fungible because exchanges expend resources to develop them and fungibility would enable other trading venues to "free ride" on these product development efforts; futures exchanges should be able to recoup their investments in (or, as some economists would term it, enjoy the rents from) their product development, and that any changes should be predicated on reform in foreign jurisdictions.

- Competition among trading venues in the futures markets could be enhanced by permitting market participants to clear trades at a clearinghouse regardless of the facility on which the trade was executed.

Manipulation, Insider Trading and Fraud Enforcement. Although the agencies share many enforcement interests, there are differences in enforcement authority and, on occasion, such as with insider trading, in overall approach.

Manipulation. Manipulation is unlawful under both the securities and futures laws. While there is some overlap in the types of manipulative activity that occur in the securities and futures markets, certain kinds of activity, such as corners and squeezes are particular to the futures markets.

Public input on this issue indicated that:

- Enforcement with respect to manipulation in the futures and securities markets requires both legal action in response to violations and prescriptive action through proper market oversight.

- While the CFTC has had success in bringing manipulation cases, its authority with respect to disruptive trading practices should be enhanced.

Insider Trading. The approaches of the securities and futures laws also diverge on the issue of insider trading. The market integrity provisions of the securities laws prohibit insider trading. They do so in large part because securities laws are premised on a corporation's duties to disclose material information to protect shareholders from corporate insiders who have access to non-public information. Specifically, corporate officials and personnel of a firm who trade that firm's securities on the basis of inside information are viewed as breaching a fiduciary duty to the shareholders hold those securities.

In contrast, the CEA's insider trading prohibitions are focused on employees and agents of the CFTC and of SROs and markets that are regulated by the CFTC. The difference between the two regimes is attributable, first, to the historical functions of the futures markets. These markets permit hedgers to use their non-public material information to protect themselves against risks to their commodity positions. Though counterparties to these kinds of transactions may not have access to the same non-public information, corporate officials and personnel generally do not have a similar fiduciary duty with respect to those counterparties; indeed, their duties are to ensure that the company properly manages its risks by trading on the best available information.

Accordingly, comments on this issue noted the following:

- Some extension of insider trading prohibition under the futures laws would be appropriate since current laws would not prohibit, for example, misappropriation of non-public government information for trading purposes (such as information depicted in the popular motion picture "Trading Places").

- Although there are different views as to precisely where the line should be drawn, commentary indicated that current prohibitions applicable to CFTC and registered entity personnel should be extended to all other SROs (such as securities exchanges), other government agencies and departments, and members of Congress and their staffs who are in possession of material non-public information.

Other Enforcement. There also are differences in enforcement remedies. A difference between the two regulatory frameworks is that the CFTC has specific statutory authority for aiding and abetting all violations of the CEA and CFTC regulations. The SEC has specific statutory authority for aiding and abetting under the Securities

Exchange Act and the Investment Advisers Act but not under the Securities Act or the Investment Company Act. Also, whereas the securities laws require BDs to maintain firewalls between the analyst and trading functions, there is no parallel mechanism for avoiding conflicts of interest under the CEA. Finally, neither agency has the ability to rely on whistleblowers to assist in detecting violations of their statutes.

Obligations to Customers. Financial intermediaries that offer investment advice to clients are subject to varying standards under the regulatory schemes of the CFTC and the SEC.

With respect to suitability, the CFTC requires financial advisers to determine an appropriate level of disclosure particularized to the client based on the "know your customer" information they have obtained. Because of the fundamental role of leverage and the inherent volatility of commodities markets, futures trading is considered "risky" by nature. Futures regulation, therefore, imposes an initial suitability determination before a customer even opens a futures trading account. However, once that threshold is crossed, the customer may engage in futures trade without a trade-by-trade suitability determination by the financial professional. This approach to suitability is generally premised on the notion that, once customers in the futures industry receive an appropriately tailored disclosure stating that all futures are risky and volatile instruments, they subsequently are in the best position to determine the propriety of a particular futures trade.

Under the federal securities laws and SRO rules, broker-dealers are required to deal fairly with their customers. This includes having a reasonable basis for recommendations given the customer's financial situation (suitability), engaging in fair and balanced communications with the public, providing timely and adequate confirmation of transactions, providing account statement disclosures, disclosing conflicts of interest, and receiving fair compensation both in agency and principal transactions. In addition, the SEC's suitability approach requires BDs to determine whether a particular investment recommendation is suitable for a customer, based on customer-specific factors and factors relating to the securities and investment strategy. A BD must investigate and have adequate information regarding the security it is recommending and ensure that its recommendations are suitable based on the customer's financial situation and needs. The suitability approach in the securities industry is premised on the notion that securities have varying degrees of risk and serve different investment objectives, and that a BD is in the best position to determine the suitability of a securities transaction for a customer. Disclosure of risks alone is not sufficient to satisfy a broker-dealer's suitability obligation. Thus, the different approaches to suitability reflect underlying differences between futures and securities markets: whereas trading in the former always involves assuming or hedging potentially significant risk, trading in the latter turns on the customer's particular investment objectives, which invites a trade-by-trade suitability determination. At this point, the Commissions do not offer a recommendation on this issue.

On the question of what duties are owed by the financial professional to the customer, the two statutory and regulatory schemes are varied. Under the SEC's regime,

investment advisers are considered fiduciaries, but BDs are not as such. While the statutes and regulations do not uniformly impose fiduciary obligations on a BD, a BD may have a fiduciary duty under certain circumstances, at times under state common law, which varies by state. Generally, BDs that exercise discretion or control over customer assets, or have a relationship of trust and confidence with their customers, are found to owe customers a fiduciary duty similar to that of investment advisers. The Administration's proposed reform legislation seeks to establish a uniform fiduciary duty standard for investment advisers and BDs who provide similar investment advisory services.

As with BDs, there are no explicitly defined fiduciary duties under the CEA or the CFTC's regulations for financial professionals such as FCMs, commodity trading advisors ("CTAs"), or commodity pool operators ("CPOs"). State common law imposes fiduciary duties upon persons who make decisions regarding the assets of others. This law generally holds that a futures professional owes a fiduciary duty to a customer if it is offering personal financial advice.

Views in this area generally indicate that:

- Having inconsistent standards for financial advisers performing similar functions causes confusion.

- There should be a uniform fiduciary duty standard of conduct for persons providing similar investment advisory services, regardless of whether that advice relates to securities or futures.

Registration and Recordkeeping Requirements. The CFTC and the SEC have separate but complementary registration, reporting and compliance regimes for intermediaries, including BDs and FCMs, and CTAs, CPOs, and investment advisers. The two agencies have worked in several areas to relieve burdens on dual registrants. For example, they have established uniform capital and related reporting requirements for firms that register as both BDs and FCMs. Moreover, certain provisions in the CEA and the Investment Advisers Act provide exemptions for investment advisers already registered with the other agency.

On recordkeeping, the CFTC and the SEC have generally similar rules for BDs and FCMs. However, the requirements diverge on how long records must be kept overall. The CFTC has an overall 5-year retention rule, whereas the SEC generally requires that some records be kept for 3 years, and others for 6 years.

- Panelists and comments have urged the agencies to develop uniform recordkeeping rules.

- With private fund managers increasingly registering with both agencies, the Commissions have been asked to consider revising certain disclosure and reporting documents applicable to dually registered private fund

advisers with the goal of easing potentially duplicative or unnecessary compliance requirements.

Regulation of Cross-Border Activity. Increasing globalization of financial markets has made the agencies' efforts regarding oversight of cross-border activity critically important. Both agencies have taken steps to encourage the cross-border flow of capital and trading while promoting adoption of robust regulatory standards throughout the world. While the basic objectives of the two agencies have been the same, their particular approaches with respect to certain cross-border access issues have differed.

Under the federal securities laws, an exchange wishing to engage in a securities business in the United States must register. The situation for foreign boards of trade ("FBOTs") under the CFTC's regulatory scheme is somewhat different; under appropriate conditions, such boards of trade may qualify for no-action relief and may provide their members or participants with access to their trading systems without seeking designation or registration under the CEA. There is no statutory registration category under the CEA for foreign boards of trade, which would enhance the CFTC's authority to oversee trading by United States entities on such platforms.

With regard to intermediaries, foreign broker-dealers' interaction with U.S. investors in securities transactions is facilitated primarily through the exemptions from U.S. broker-dealer registration offered under the Securities Exchange Act. The CFTC's regulatory regime allows for broader cross-border access by intermediaries.

- The agencies should continue to cooperate with their foreign counterparts to seek global regulatory harmonization, especially with regard to the regulation of over-the-counter derivatives.

- The SEC and CFTC regimes should further encourage cross-border access with respect to securities transactions in the secondary market consistent with fair and orderly markets, standards of full and fair disclosure, and the protection of investors in the United States.

Operational Coordination. Improving coordination and cooperation between the SEC and CFTC is essential to achieving the Administration's directive on harmonization going forward. Accordingly, the Report concludes with several recommendations that will allow the SEC and the CFTC to better coordinate their operations, information-sharing, and regulations.

- An appropriate forum for discussion and communication between the SEC and the CFTC to identify emerging regulatory risks and assess and quantify their implications for investors and other market participants, and provide recommendations for solutions would serve the agencies' harmonization initiative.

- A number of panelists at the September Meeting endorsed creation of a task force on enforcement matters that would consist of staff from each agency to coordinate joint investigations in response to events that affect both the securities and futures markets. Such an initiative would help eliminate inefficiencies, and ensure comprehensive and consistent fraud and manipulation detection across the two marketplaces.

Summary of Recommendations

Markets

1. The Report recommends legislation to facilitate the holding of (i) futures products in an SRO securities portfolio margin account and (ii) securities options, SFPs, and certain other securities derivatives in a futures portfolio margin account. In addition, the Commissions should undertake to review their existing customer protection, margin and any other relevant regulations to determine whether any rule changes or exemptive relief would be necessary to achieve the full benefits of risk-based portfolio margining. The Commissions should also undertake, with input from experts, the industry, and the public, to explore whether further modifications to portfolio margining, including adoption of a one account model that would accommodate all financial instruments and all broker-dealers and FCMs, would be in the public interest.

2. The Report recommends legislation that would provide a process for expedited judicial review of jurisdictional matters regarding new products. Specifically, the SEC and the CFTC support legislation to establish and clarify: (i) legal certainty with respect to the agencies' authority over products exempted by the other agency; and (ii) a review process to ensure that any jurisdictional dispute is resolved by the Commissions against a firm timeline.

3. The Report recommends legislation to enhance CFTC authority over exchange and clearinghouse compliance with the CEA. The CFTC currently lacks sufficient authority to ensure that exchanges and clearinghouses it regulates are operating within the principles, rules and regulations established under the CEA, adapt to market conditions and international standards, and protect the public. The CEA should be amended to provide the CFTC with clear authority with respect to exchange and clearinghouse rules that the CFTC determines are necessary for them to comply with the CEA.

4. The Report recommends that the SEC review its approach to cross-border access to determine whether greater efficiencies could be

achieved with respect to cross-border transactions in securities consistent with the protection of investors and the public interest. The SEC intends to undertake a focused review of its approach to cross-border access. In particular, the SEC intends to consider whether its current approach could be modified to achieve greater efficiencies regarding cross-border securities transactions without impairing investor protections.

5. The Report recommends legislation to empower the CFTC to require foreign boards of trade to register with the CFTC. Because there is no statutory registration requirement under the CEA for FBOTs, the CFTC's authority to oversee trading by United States entities abroad is limited. Therefore, the CFTC recommends that the CEA be amended to grant the agency authority to require registration of any FBOT that seeks to provide direct access to members or other participants located in the United States and, when appropriate, relying on the foreign regulator to avoid duplicative regulation.

Financial Intermediaries

6. The Report recommends legislation that would impose a uniform fiduciary duty on intermediaries who provide similar investment advisory services regarding futures or securities. Consistent with Title IX of the Administration's financial regulatory reform legislation, which seeks to establish a uniform standard of conduct for broker-dealers and investment advisers, the agencies recommend that a consistent standard apply to any CTA, FCM, introducing broker ("IB"), broker-dealer, or investment adviser who provides similar investment advisory services.

7. The Report recommends that the SEC and the CFTC undertake to align their record retention requirements for intermediaries by harmonizing the length of time records are required to be maintained. The SEC intends to review its current three (3) and six (6) year record retention requirements and consider, as appropriate, rule changes that would harmonize these requirements with the five (5) year record retention requirements the CFTC makes applicable to CFTC registrants.

8. The Report recommends that the agencies undertake to provide greater consistency in their customer risk disclosure documents. The SEC intends to review the current Options Disclosure Document ("ODD") to determine whether a customer disclosure document more akin to that which is used for futures products would be appropriate and consistent with the protection of investors and the public interest.

9. The Report recommends efforts to align specific private fund reporting requirements. The CFTC and the SEC should review regulatory requirements applicable to investment advisers and commodity trading advisors/commodity pool operators with respect to private funds to eliminate, as appropriate, any inconsistent or conflicting provisions regarding: (i) the use of performance track records; (ii) requirements applicable to investor reports (including the financial statements often used by registered investment advisers to comply with the Advisers Act custody rule and the financial statements delivered to investors by commodity pool operators); and (iii) recordkeeping requirements.

10. The Report recommends legislation to expand the CFTC's conflict of interest prevention authority. Legislation should be enacted to authorize the CFTC to require FCMs and IBs to implement conflict of interest procedures that would separate the activities of persons in a firm engaged in research or analysis of commodity prices from those involved in trading or clearing activities.

Enforcement

11. The Report recommends legislation on whistleblower protections. Consistent with Title IX of the Administration's proposed financial regulatory reform legislation, legislation should be enacted to encourage whistleblowers to come forward with relevant information to authorities in both SEC and CFTC registered markets.

12. The Report recommends legislation that would address customer restitution in CFTC enforcement actions. The CFTC currently has express authority to seek restitution for investor losses in administrative proceedings. However, the legislation should clarify that restitution in civil actions is defined in terms of the losses sustained by persons as a result of the unlawful conduct.

13. The Report recommends legislation to enhance the CFTC's authority over disruptive trading practices. Legislation should be enacted to enhance the CFTC's enforcement authorities with respect to certain disruptive practices that undermine market integrity and the price formation process in the futures markets.

14. The Report recommends legislation to expand the scope of insider trading prohibitions under the CEA. Specifically, the CEA should be amended to make unlawful the misappropriation and trading on the basis of material non-public information from any governmental authority.

15. The Report recommends legislation that would grant the SEC specific statutory authority for aiding and abetting under the Securities Act and the Investment Company Act. The CFTC has specific statutory enforcement authority for aiding and abetting all violations of the CEA and CFTC rules and regulations. Expanding the SEC's statutory authority to allow the SEC to bring actions for aiding and abetting violations of the Securities Act and the Investment Company Act would close the gap between the SEC and CFTC's regulatory regimes.

Operational Coordination

16. The Report recommends legislation to authorize the SEC and the CFTC to jointly form, fund, and operate a Joint Advisory Committee that would be tasked with considering and developing solutions to emerging and ongoing issues of common interest in the futures and securities markets. Specifically, the Joint Advisory Committee would identify emerging regulatory risks and assess and quantify their implications for investors and other market participants, and provide recommendations for solutions.

17. The Report recommends that the agencies create a Joint Agency Enforcement Task Force to harness synergies from shared market surveillance data, improve market oversight, enhance enforcement, and relieve duplicative regulatory burdens. The task force would prepare and offer training programs for the staffs of both agencies, develop enforcement and examination standards and protocols, and coordinate information sharing. The task force also would oversee temporary details of personnel between the agencies to assist in furthering the aforementioned objectives.

18. The Report recommends that the SEC and the CFTC should establish a joint cross-agency training program for staff. The Commissions believe that joint training programs for enforcement personnel would be highly beneficial. The training program would be for staff at both agencies, and would focus on enforcement matters.

19. The Report recommends to develop a program for the regular sharing of staff through detail assignments. The agencies anticipate that, through this program, each year several staff from each agency will have the opportunity to work at the other agency through temporary detail positions for a specified period of time. Implementing a program where staff engages in a rotation between the two agencies will allow for greater collaboration and coordination between the two agencies.

20. The Report recommends that the agencies develop a Joint Information Technology Task Force to pursue linking information on CFTC and

> SEC regulated persons made available to the public and such other information as the Commissions find jointly useful and appropriate in the public interest. Linking publicly-filed information and such other information as the Commissions jointly find useful and appropriate in the public interest residing with the two agencies would promote transparency and facilitate the use and understanding of such information by providing a comprehensive, consolidated database on persons and entities regulated by the SEC and the CFTC.

I. Introduction

On June 17, 2009, the Treasury Department released a White Paper[4] to set the foundation for restoring confidence in the integrity of the US financial system. Noting that "[t]he broad public policy objectives of futures regulation and securities regulation are the same: protecting investors, ensuring market integrity, and promoting price transparency,"[5] the White Paper called on the SEC and CFTC to identify "all existing conflicts in statutes and regulations with respect to similar types of financial instruments and either explain why those differences are essential to achieve underlying policy objectives with respect to investor protection, market integrity, and price transparency or make recommendations for changes to statutes and regulations that would eliminate the differences."[6]

While the CFTC and SEC share these broad regulatory objectives, historically, futures regulation and securities regulation have occupied distinct areas of market activity. In the last quarter century, however, with the proliferation of new financial instruments, the two markets have begun to overlap.

<u>The Evolution of Financial Markets and Overlapping Jurisdiction</u>

When Congress originally established the CFTC in 1974, its jurisdiction and the SEC's jurisdiction could be delineated with relative clarity to refer to distinct markets. The line defining their jurisdictional divide began to erode with the development of derivative financial products. The emergence of financial instruments such as swaps, stock-index futures, and other derivative instruments, some of which were traded off-exchange, began to introduce challenges to defining precisely which regime should oversee the new products.[7]

From the beginning, the two agencies began to seek ways to cooperate in resolving jurisdictional disputes. In 1981, for example, the CFTC and the SEC negotiated an agreement that divided jurisdiction and regulatory responsibility over stock

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4 Treasury White Paper, *supra* note 1.

5 *Id*. at 49.

6 *Id*. at 50–51.

7 *See* U.S. Gen. Accounting Office, The Commodity Exchange Act: Issues Related to the Commodity Futures Trading Commission's Reauthorization, GAO/GGD-99-74, 19 (May 1999).

index futures and options between the two agencies. The agreement, known as the Shad-Johnson Accord, was later codified in the Futures Trading Act of 1982,[8] which remained in place for almost two decades. In the same spirit, in 1989, the CFTC issued a policy statement regarding swaps in which it identified certain transactions that it would decline to regulate as futures or futures options.[9]

Critics have stated that the agencies' attempts to define their respective jurisdictions never fully succeeded. First, governing statutes never definitively addressed the fundamental question of whether certain derivative instruments qualified as futures contracts or options. Moreover, financial engineers developed products that had attributes of both futures and securities, thus helping to confuse the line between futures and securities regulation. One example is when several exchanges developed index participations. These contracts are based on the value of an index of securities, usually cash-settled, and they are designed to trade as securities on securities exchanges. A federal court of appeals, which presided over a phase of litigation proceedings involving a jurisdictional dispute over these products, concluded that index participations were both futures and securities and then determined that the CFTC's exclusive jurisdiction over futures meant that the securities laws did not apply.[10]

The developing overlaps were not limited to jurisdiction over products. In the past twenty years, there has also been convergence of marketplaces and market participants such that the same entity is subject to the regulatory authority of both the SEC and the CFTC. For example, exchanges that list and trade security futures are subject to the jurisdiction of both the SEC and the CFTC. Financial intermediaries register with both the SEC and CFTC, as they serve investors who trade in instruments that are subject to the jurisdiction of the two agencies. For instance, approximately 45% of FCMs are also registered with the SEC as BDs. In addition, 262 ,or approximately 2.3%, of SEC-registered advisers, are also registered as CTAs or CPOs.

Due to the continued challenge posed by evolving market realities, the agencies have continued efforts to work together in various areas. The SEC and the CFTC have had longstanding cooperation in enforcement matters. For example, over the last year, 65% of the CFTC's fraud cases have involved cooperative efforts with the SEC and almost 40% resulted in joint case filings. The agencies have also sought to formalize their cooperation. In March 2004, the agencies signed a memorandum of understanding, agreeing to share information regarding security futures, which are regulated by both agencies.[11] More recently, in March 2008, the SEC and the CFTC entered into the Memorandum of Understanding Regarding Coordination in Areas of Common Regulatory Interest ("MOU") with the goal of creating a closer relationship between the

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8 Pub. L. No. 97-444, 96 Stat. 2294 (1983).

9 CFTC Swaps Policy Statement, 54 FR 30694 (July 21, 1989).

10 *See Chicago Mercantile Exchange v. SEC*, 883 F.2d 537, 544 (7th Cir. 1989).

11 Memorandum of Understanding Regarding Oversight of Security Futures Product Trading and Sharing of Security Futures Product Information (March 17, 2004).

agencies on a broad range of issues affecting their jurisdictions.[12] The agreement identified points of contact for coordination, outlined a protocol for addressing novel derivative products, and generally contemplated enhanced information sharing between the two agencies on areas of mutual concern and interest. The agencies have also been active in joint initiatives involving rulemakings or orders. Some of the recent rulemaking has related to security futures.[13] Other examples have concerned narrow-based security index products, exchange-traded funds ("ETFs"), and margin requirements for security futures products ("SFPs").[14]

The Financial Crisis and the Impetus for Reform

The call for comprehensive financial regulatory reform followed the worst financial crisis the nation has suffered in over half a century. On June 17, 2009, the Treasury White Paper outlined a roadmap for restoring confidence in the integrity of the financial system.[15] The Treasury White Paper asked the SEC and the CFTC to prepare a report that would identify differences between their regulatory schemes, would determine whether the differences were justified by differences in the nature of the markets, and otherwise would recommend changes to harmonize futures and securities regulation.

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12 Memorandum of Understanding Between the U.S. Securities and Exchange Commission and the U.S. Commodity Futures Trading Commission Regarding Coordination in Areas of Common Regulatory Interest (March 11, 2008), *available at* http://www.sec.gov/news/press/2008/2008-40_mou.pdf.

13 In 2006, the SEC and CFTC adopted SEC Rule 6h-2, 17 CFR 240.6h-2, and an amendment to CEA Rule 41.21, 17 CFR 41.21, respectively, to permit security futures to be based on individual debt securities or narrow-based indexes composed of such securities. *See* Securities Exchange Act Release No. 54106 (July 6, 2006) 71 FR 39534 (July 13, 2006). That rulemaking also adopted SEC Rule 3a55-4, 17 CFR 240.3a55-4, and CFTC Rule 41.15, 17 CFR 41.15, excluding indexes of debt securities that meet certain specified criteria from the definition of "narrow-based security index".

14 Since 2001, the agencies have engaged in a number of other joint initiatives involving rulemaking or orders. *See, e.g.*, Securities Exchange Act Release Nos. 44724 (August 20, 2001), 66 FR 44490 (August 23, 2001) (adopting rules establishing the method for determining the "market capitalization" and "dollar value of average daily trading volume" for purposes of the statutory definition of a "narrow-based security index"); 46009 (May 31, 2002), 67 FR 38941 (June 6, 2002) (excluding from the definition of "narrow-based security index" indexes that qualified for the exclusion from that definition under Section 1a(25)(B)(v) of the CEA and Section 3(a)(55)(C)(v) of the Securities Exchange Act); 45956 (May 17, 2002), 67 FR 36740 (May 24, 2002) (requiring that the final settlement price for cash-settled SFPs fairly reflect the opening price for the underlying security or securities, and that trading in any SFP halt when a regulatory halt is instituted with respect to a security or securities underlying the SFP); 46292 (August 1, 2002), 67 FR 53146 (August 14, 2002) (establishing margin requirements for security futures); 46473 (September 9, 2002), 67 FR 58284 (September 13, 2002) (requiring all firms conducting business in security futures products to make certain disclosures to customers); 46090 (June 19, 2002), 67 FR 42760 (June 25, 2002) (permitting depository shares and shares of Exchange-Traded Funds, Trust Issued Receipts, and registered closed-end management investment companies to underlie security futures); and 49469 (Mar. 25, 2004), 69 FR 16900 (Mar. 31, 2004) (excluding indexes comprised of certain index options from the definition of "narrow-based security index").

15 *See* Treasury White Paper, *supra* note 1.

In response to this call, on August 20, 2009, the SEC and the CFTC announced that they would hold a joint meeting to hear from the public regarding the most pressing issues for regulatory harmonization. Chairman Gensler of the CFTC noted that "[h]armonizing our regulatory policies will improve market integrity by applying consistent standards to market participants. There are three areas where this review will most benefit the American public: to address gaps between the two agencies' financial regulatory authorities, to assess the effects of regulatory overlap, and to bring appropriate consistency to the two agencies' regulation over similar products, practices and markets."[16] Chairman Schapiro of the SEC observed that "[t]hese joint meetings will build on the progress the CFTC and the SEC have made on designing a framework to regulate OTC derivatives. It will move us further down the road of harmonizing our regulations to increase transparency, reduce regulatory arbitrage and rebuild confidence in our markets."[17]

The two agencies invited experts and representatives of stakeholders to speak at the public meeting. Public comment was also invited. The historic event – this was the first time that the agencies have held a joint public meeting – took place on September 2 and 3, 2009 ("September Meeting"), with the participation of all sitting Commissioners of both agencies. The September Meeting convened five panels on which a total of 30 panelists participated. Members of the investor community, academics, industry experts, and market participants explored topics ranging from exchange, market, and clearing issues, to regulation of intermediaries and end-users, to enforcement.[18] The agencies received 14 comments from the public and the panelists submitted written statements reflecting the views they had expressed.[19]

The Joint Report

During the September Meeting, the Commissioners and panelists identified a number of areas in which the statutory and regulatory schemes differ.[20] In some instances, panelists made specific proposals for reform with respect to the issues; in others, they noted that differences between the regulatory schemes of the SEC and the CFTC do not necessarily imply the existence of a regulatory gap or inconsistency. Rather, as indicated by the nature of the two markets, the panelists noted that there are some inherent differences between securities and futures regulation.

This Report builds on the comments and observations offered during the September Meeting. It will review the following areas: (i) product listing and approval;

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16 *See* Press Release: SEC, CFTC to Hold Joint Meetings on Regulation Harmonization (August 20, 2009), *available at* http://www.sec.gov/news/press/2009/2009-186.htm or *at* http://cftc.gov/newsroom/generalpressreleases/2009/pr5696-09.html.

17 *See id.*

18 *See* Transcripts, *supra* note 3.

19 Written testimony by the panelists and public comments are available on the agencies' websites: at the SEC, http://www.sec.gov/comments/4-588/4-588.shtml; at the CFTC, http://www.cftc.gov.

20 *See* Transcripts *supra* note 3.

(ii) exchange/clearinghouse rule changes; (iii) risk-based portfolio margining and bankruptcy/insolvency regimes; (iv) linked national market and common clearing versus separate markets and exchange-directed clearing; (v) market manipulation and insider trading; (vi) customer protection standards applicable to financial advisers; (vii) regulatory compliance by dual registrants; and (viii) cross-border regulatory matters. After describing the statutory and regulatory framework with respect to each issue, the Report then analyzes the differences and inter-play between the agencies' frameworks with specific reference to views expressed by panelists and commentators.

The CFTC and SEC also offer a series of recommendations. Some of these recommendations require legislative change by Congress. But others are within the authority of the agencies to pursue. The two Commissions are prepared to work together in an effort to make progress on those recommendations. This Report serves as a significant step in the agencies' continuing efforts on the path toward reform. The Commissioners and staff at both the SEC and the CFTC are fully committed to their respective missions, and to their overall goal of protecting investors, the marketplace, and the American public.

II. Discussion of CFTC and SEC Regulatory Approaches

A. Oversight of New Products

As the Treasury White Paper notes, the CFTC and SEC are governed by two different approaches to the regulation of exchanges and clearing organizations. In certain areas, this basic difference affects the way in which the two agencies approach review and approval of new products for listing. In addition, as the Treasury White Paper observes, many financial products "have attributes that may place the instrument within the purview of both regulatory agencies."[21] As many commentators, including participants in the September Meeting, have explained, the resulting jurisdictional overlap has caused the agencies to expend considerable resources to determine the regulatory requirements for such instruments.

1. SEC Regulatory Framework

The Securities Exchange Act[22] requires a national securities exchange to have rules governing the listing and trading of securities on its market.[23] Before an issuer can list a class of its securities for trading on a national securities exchange, such class of securities must be registered under Section 12(b) of the Securities Exchange Act.[24]

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21 *See* Treasury White Paper, *supra* note 1.

22 15 U.S.C. 78a *et seq*.

23 *See* Section 6 of the Securities Exchange Act, 15 U.S.C. 78f.

24 15 U.S.C. 78l(b). Issuers that list on the NYSE, American Stock Exchange ("Amex") or NASDAQ Stock Market ("Nasdaq"), as well as any other national securities exchange which the SEC has determined has substantially similar listing standards to those of NYSE, Amex or Nasdaq, are generally exempt from state blue sky laws. Section 18(a) of the Securities Act of 1933. 15 U.S.C. 77r(a).

The securities laws are premised on the notion of high quality disclosure of material information about an issuer's securities. Registration and periodic reporting requirements for an issuer's securities are prescribed under the Securities Act of 1933 ("Securities Act")[25] and the Securities Exchange Act.[26] These requirements are designed to assure that there is public information available to enable investors to make informed judgments about whether to purchase or sell an issuer's securities. Such judgments involve capital allocation decisions, and therefore consideration of not just market information, such as price and volume, but also business and financial information.[27] Investors who purchase securities and suffer losses have important remedies if the securities were offered in violation of the registration requirements, or if the offering disclosure included an untrue statement of a material fact or omitted to state a material fact necessary to make the statements not misleading.[28] These disclosure obligations on issuers apply whether a security trades in the over-the-counter market or is listed on an exchange. An exchange that lists securities has additional obligations, which are discussed below.

An issuer that seeks to list on an exchange must also satisfy initial listing standards established by the exchange. For example, exchange listing standards establish minimum distribution and financial criteria for the issue of securities and/or the issuer.[29] Issuers must meet the exchange's corporate governance standards, which generally require that a majority of the issuer's directors be independent and that certain committees, including the audit committee, be fully independent, as well as other governance-related matters.[30] These exchange rules cover the listing process for a wide range of securities such as common stock, preferred stock, warrants, convertible securities, and debt securities that are issued by entities including operating companies, closed-end companies, real estate investment trusts, acquisition companies, and foreign private issuers. To continue to be listed on the exchange, an issuer's securities must be able to satisfy continuing listing requirements under exchange rules.

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25 15 U.S.C. 77a *et seq*.

26 *See supra* note 22.

27 This discussion focuses on issuer disclosure related to the purchase or sale of securities. Often included in the bundle of rights that comprise a security is the right to vote on certain issuer matters. The SEC has, pursuant to the Securities Exchange Act, promulgated rules designed to assure that when security holders are asked to vote by proxy, information is provided to them to enable investors to make informed voting decisions. The ability to employ derivatives such as futures and options on securities to separate economic and voting rights is one reason why regulation of securities and derivatives of securities should be consistent and coordinated.

28 Sections 11 and 12(a) of the Securities Act. 15 U.S.C. 77k and 77l(a).

29 *See, e.g.,* Sections 102.00-106.03 of the New York Stock Exchange ("NYSE") Listed Company Manual and Nasdaq Rules 5200-5560.

30 *See, e.g.,* Sections 301.00-315.00 of the NYSE Listed Company Manual and Nasdaq Rules 5600-IM5640. *See also* Section 10A of the Securities Exchange Act (15 U.S.C. 78j-1) and Rule 10A-3 thereunder (17 CFR 240.10A-3), which relates to audit committee independence, among other things.

Options and security futures listed on a national securities exchange are exempt from registration with the SEC.[31] However, exchange rules generally only permit trading in options and futures on securities registered under Section 12(b) of the Securities Exchange Act.[32] Options exchange listing requirements establish requirements for the underlying securities or index. For example, the rules of the Chicago Board Options Exchange ("CBOE") require that the underlying security have: a minimum of 7,000,000 shares owned by public investors; a minimum of 2,000 holders; and trading volume of at least 2,400,000 shares in the preceding twelve months.[33]

The SEC also regulates the listing and trading of derivative securities products other than equity and index options. These derivative securities products include a wide range of securities whose value is based, in whole or in part, upon the performance of, or interest in, an underlying instrument or group or index of securities. These products include equity-based derivative securities products, commodity- and currency-based derivative securities products, and structured notes, among others. As for all securities that an exchange lists and trades, an exchange must have in place listing standards for these types of derivative securities products that are consistent with the Securities Exchange Act and rules promulgated thereunder.

For these types of securities, exchanges may establish "generic" listing standards for a particular class of derivative securities products, such as exchange-traded funds, index-linked securities, and equity-linked notes. Like the listing standards for other types of securities, such listing standards would typically require minimums relating to the number of publicly held trading units, number of holders, and the principal amount or market value outstanding. These rules also generally seek to ensure the fair and timely disclosure of information to all market participants.[34] Another common key element in listing standards of derivative securities products is the restriction of the use and dissemination of material, non-public information relating to composition of, and changes made to, the index or investments comprising the portfolio underlying the derivative securities product.[35]

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31 *See* Section 12(a) of the Securities Exchange Act, 15 U.S.C. 78l(a).

32 *See* Section 6(h)(3)(A) of the Securities Exchange Act, 15 U.S.C. 78f(h)(3)(A), and Section 2(a)(1)(D)(i)(I) of the CEA, 7 U.S.C. 2(a)(1)(D)(i)(I).

33 CBOE Rule 5.3. The underlying security must also be a National Market System ("NMS") stock, as defined in Rule 600 of Regulation NMS under the Securities Exchange Act. *See* CBOE Rule 5.3(a)(1).

34 For example, listing standards typically include requirements relating to the calculation and dissemination of key values pertaining to the shares of, and the assets underlying, the derivative securities product, such as that: (1) the value of the derivative securities product's underlying asset or index, as the case may be, must be calculated and disseminated at regular intervals during the trading day; (2) the derivative securities product's intraday indicative value must be calculated and disseminated at least every 15 seconds during the trading day; and (3) the net asset value and the composition of the portfolio, if applicable, of the derivative securities product must be available to all market participants at the same time. If such information is not being disseminated as required, the listing standards would also specify when a trading halt would be appropriate.

35 For example, for index-based derivative securities products, if the underlying index is maintained by a broker-dealer, the broker-dealer would be required to erect a "firewall" around the personnel

Derivative securities products that qualify for listing and/or trading under "generic" listing standards may commence trading once they satisfy the applicable listing requirements. Exchanges listing or trading a derivative securities product under "generic" listing standards must submit to the SEC Form 19b-4(e) within five business days after trading commences for such security. The purpose of this requirement is to notify the SEC when an exchange begins to trade a derivative securities product.

Certain securities may not fit within approved listing standards of an exchange or may be of a class of derivative securities products that may not be listed or traded pursuant to "generic" listing standards. In such cases, the exchange would be required to submit a proposed rule change pursuant to Section 19(b)(1) of the Securities Exchange Act to list and trade the specific security.[36]

Exchanges have made substantial use of the process afforded to them for derivative securities products under "generic" listing standards pursuant to Rule 19b-4(e). The chart below describes the number of filings by type, for derivative securities products (other than listed equity and index options), as well as the number of derivative securities products listed and traded pursuant to those filings, for SEC fiscal years 2007 and 2008.[37]

Form Type	**FY 2007**		**FY 2008**	
	Total Filed	Total Derivative Securities Products Listed and/or Traded	Total Filed	Total Derivative Securities Products Listed and/or Traded
Proposed	62	522	50	378

responsible for the maintenance of such index or who have access to information concerning changes and adjustments to the index, and, in such cases, a third party that is not a broker-dealer would be required to calculate the index value. Similarly, for derivative securities products that are based on a portfolio that is actively managed by a registered investment adviser, if the investment adviser is affiliated with a broker-dealer, such investment adviser is required to erect a firewall between itself and the broker-dealer affiliate with respect to access to information concerning the composition and/or changes to the portfolio.

36 The SEC generally must either approve the proposed rule change or institute disapproval proceedings within 35 days of the publication of notice of the filing. The SEC must approve a proposed rule change if it finds that the rule change is consistent with the requirements of the Securities Exchange Act and the rules and regulations thereunder applicable to the exchange proposing the rule change. The SEC also may approve a proposed rule change on an accelerated basis prior to 30 days after publication of the notice if the SEC finds good cause for so doing and publishes its reasons for so finding. *See* 15 U.S.C. 78s(b)(2). In addition, certain proposed rule changes may be filed for immediate effectiveness under Section 19(b)(3)(A) of the Securities Exchange Act. *See* 15 U.S.C. 78s(b)(3)(A).

37 An SRO sometimes seeks to list and trade more than one derivative securities product per Form 19b-4. In addition, SROs have sometimes submitted a single Form 19b-4(e) for more than one derivative securities product.

rule change				
Generic Listing	1,589	2,010	1,277	2,136

These statistics reflect that, in recent years, the overwhelming majority of derivative securities products are listed and/or traded pursuant to the streamlined process under Rule 19b-4(e).

2. CFTC Regulatory Framework

Before passage of the CFMA,[38] contracts could not be listed unless they satisfied an "economic purpose" criterion. This standard required that exchanges affirmatively demonstrate to the CFTC that a proposed contract could be used for hedging or price basing. The CFMA repealed that provision. Thus, although after the CFMA, the CEA still gives the CFTC authority over a decision by an exchange, or designated contract market ("DCM"), to list new contracts for trading, products may be listed unless the CFTC determines that they "would violate" the CEA.[39] Under the provisions of the CEA, among other things, a DCM only may list contracts that are not readily susceptible to manipulation.[40]

Generally, under the CEA, new contracts may be listed through a self-certification process or after approval by the CFTC pursuant to prior review procedures.[41] Most products are listed pursuant to self-certification. The process of self-certification reflects the principles-based approach to oversight, whereby, with certain exceptions, exchanges (and clearinghouses) generally have reasonable discretion in establishing the manner in which they comply with the core principles outlined in the statute.[42] By filing a self-certification, a DCM certifies that the contract, or new financial product, complies with the CEA and CFTC regulations. The self-certification process requires submissions to be filed with the agency no later than one full CFTC business day before initial implementation of the product listing.[43] A submission relating to a product approval must include a copy of the product's rules, including all rules related to its terms and conditions, or the rules establishing the terms and conditions of the listed product that make it acceptable for clearing.[44] While the CFTC primarily relies on the DCM's

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38 Appendix E of Pub. L. No. 106-554, 114 Stat. 2763 (2000).

39 CEA Section 5c(c)(3), 7 U.S.C. 7a-2(c)(3)

40 CEA Section 5(d)(3), 7 U.S.C. 7(d)(3).

41 CEA Sections 5c(c)(1)-(2), 7 U.S.C. 7a-2(c)(1)-(2).

42 *See, e.g.*, CEA Section 5(d)(1), 7 U.S.C. 7(d)(1), and CEA Section 5b(c)(2), 7 U.S.C. 7a-1(c)(2).

43 CFTC Regulation 40.6, 17 CFR 40.6.

44 *Id.*

certification that the contract terms and conditions comply with the CEA and the CFTC's regulations, CFTC staff conducts a due diligence review.[45]

If an entity seeks prior approval for listing a product, its submission must include, among other things, a copy of the rules that set forth the contract's terms and conditions and a demonstration of compliance with CFTC regulations.[46] Compliance requires: an explanation of how the specific terms and conditions satisfy acceptable practices as set forth in CFTC guidelines; for physical delivery contracts, an explanation of how terms and conditions will result in a deliverable supply that will not be conducive to price manipulation or distortion; for cash-settled contracts, an explanation how the cash settlement of the contract is at a price reflecting the underlying cash market, will not be subject to manipulation or distortion, and is based on a cash price series that is reliable, acceptable, publicly available and timely; a brief description of the cash market for the commodity; a description of agreements or contracts entered into with other parties that enable the registered entity to carry out its responsibilities; and certifications for product approval of a commodity that is a security future or a SFP.[47] Products that are submitted for prior approval are subject to a 45-day review period (or a 90-day period for products deemed to be novel or complex)**.** Again, the CFTC must approve the new products unless it affirmatively finds that listing or clearing the products would violate the CEA.[48]

3. Analysis of SEC/CFTC Regulatory Frameworks

The SEC and CFTC have different product introduction and approval processes. With certain exceptions,[49] derivatives on securities may be listed on securities exchanges without filing a proposed rule change with the SEC. Instead, these products are listed under previously approved exchange listing rules.[50] Most new derivative products listed on a securities exchange have tended to fall within previously approved "generic" listing

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45 The CEA and CFTC regulations contain an exception to self-certification for material amendments to terms or conditions of a contract for future delivery of an enumerated agricultural commodity -- which includes basic agricultural commodities such as wheat, cotton, rice, corn, oats, butter, eggs, wool, soybeans and livestock – or an option on such a contract or commodity in a delivery month having open interest. Such contracts must receive prior CFTC approval. The exceptions are enumerated in Section 1a(4) of the CEA, 7 U.S.C. 1a(4). *See also* Section 5c(c)(2)(B), 7 U.S.C. 7a-2(c)(2)(B); CFTC Regulation 40.4, 17 CFR 40.4.

46 Appendix A to Part 40 – Guideline No. 1, 17 CFR Part 40, Appendix A.

47 CFTC Regulation 40.3, 17 CFR 40.3.

48 CEA Section 5c(c)(3), 7 U.S.C. 7a-2(c)(3).

49 The exception is "new derivative products" which consists of any type of option, warrant, hybrid securities product or any other security, other than a single equity option or a security futures product, whose value is based, in whole or in part, upon the performance of, or interest in, an underlying instrument. *See* 17 CFR 240.19b-4(e).

50 In SEC fiscal year 2007, a total of 2,010 new derivative securities products were listed and traded, or traded pursuant to unlisted trading privileges. In SEC fiscal year 2008, a total of 2,136 new derivative securities products were listed and traded, or traded pursuant to unlisted trading privileges.

standards and, accordingly, no prior approval has been required before commencement of trading. In these circumstances, the exchange must file a notice with the SEC within five days after trading begins. New derivative products that are novel and therefore do not fit within existing listing standards, however, must be approved by the Commission.

The CEA, by contrast, generally allows for the introduction of all products to the market upon certification by a DCM that the product does not violate the CEA or CFTC regulations. The CFTC conducts due diligence reviews of all self-certified products to ensure compliance with statutory and regulatory requirements. Generally, the level of scrutiny for these reviews is commensurate with the complexity of the product, with innovative or novel products receiving more detailed review. Ultimately, however, the CFTC may not move to de-list the product unless it determines that the listing violates the CEA.

Most panelists generally favored streamlined product listing and approval procedures.[51] Some recommended that the SEC adopt a certification regime similar to that of the CFTC for product introduction.[52] As an alternative, it was suggested that the SEC set strict time limits on product approvals.[53] There currently are time restrictions under the SEC's product approval process. The Commission must approve or institute disapproval proceedings for proposals within 35 days of the date of publication. Further, pursuant to the SEC's recently approved process for streamlining rule changes, proposals generally must be published within 15 days of receipt. This new process was designed to balance regulatory certainty and fostering innovation with adequate time for deliberation. Even as panelists advocated streamlined procedures, however, they acknowledged that exchanges certifying that a rule or product is in compliance with underlying laws and regulations should bear the burden of showing compliance upon certification,[54] and that the agencies should retain the authority to disapprove a contract or rule.[55]

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51 *See e.g.*, Testimony of Craig Donohue, Chief Executive Officer, CME Group, Inc., September 2, 2009 ("Donohue Testimony"); Larry Leibowitz, Group Executive Vice President, NYSE Euronext, Inc., September 2, 2009 ("Leibowitz Testimony"); and Peter Reitz, Member of the Executive Board, Eurex, September 2, 2009 ("Reitz Testimony"); *see also* letter from John Yetter, Vice President and Deputy General Counsel, NASDAQ OMX Group, Inc. ("Nasdaq"), to Elizabeth M. Murphy, Secretary, SEC, and David Stawick, Secretary, CFTC, dated September 14, 2009 ("Nasdaq Comment Letter").

52 *See* Testimony of William Brodsky, Chairman and Chief Executive Officer, Chicago Board Options Exchange, September 2, 2009 ("Brodsky Testimony"); Kenneth Raisler, Partner, Sullivan & Cromwell, LLP, September 3, 2009 ("Raisler Testimony"); and Leibowitz Testimony, *supra* note 51; *see also* letter from Ira Hammerman, Senior Managing Director and General Counsel, Securities Industry and Financial Markets Association ("SIFMA"), to Elizabeth M. Murphy, Secretary, SEC, and David Stawick, Secretary, CFTC, dated September 14, 2009 ("SIFMA Comment Letter") and letter from Boston Options Exchange, Chicago Board Options Exchange, International Securities Exchange, NASDAQ Options Market, NASDAQ OMX PHLX, and the Options Clearing Corporation, to Elizabeth M. Murphy, Secretary, SEC, and David Stawick, Secretary, CFTC, dated September 16, 2009 ("Options Exchanges Comment Letter").

53 *See* Leibowitz Testimony, *supra* note 51 and Donohue Testimony, *supra* note 51.

54 *See* Testimony of Sharon Brown-Hruska, Vice President, NERA Economic Consulting, September 3, 2009 ("Brown-Hruska Testimony").

55 *See* Leibowitz Testimony, *supra* note 51.

The issue that garnered greater attention at the September Meeting was the experience of past disagreements between the CFTC and the SEC regarding which agency had jurisdiction over particular products. One panelist referred to this as "the most vexing aspect of split jurisdiction."[56] In the past, the issue arose because of uncertainty as to proper classification of the product. In the absence of agreement by the agencies, there occasionally have been lengthy delays attendant to bringing new products to market. The lack of legal certainty is costly and confusing to market participants, and it can impede innovation, undermine competition.

Panelists acknowledged that the agencies have recognized that coordination on new product approvals is crucial.[57] For example, the CFTC and the SEC entered into a MOU in 2008 to coordinate "[p]roposals to list or trade novel derivative products."[58] Nonetheless, panelists pointed to past examples of the agencies' inability promptly to resolve jurisdictional issues and, in the absence of substantive legislation more clearly defining the jurisdictional boundaries between the two agencies, suggested a number of potential procedures for resolving the inter-agency disputes.[59] In the absence of legislation to clarify jurisdiction, one approach mentioned was to develop express timelines for approval once a product has been submitted for review and a mechanism for final arbitration should the agencies become deadlocked in their discussions.[60] The Treasury Department and the President's Working Group on Financial Markets were mentioned as potential arbiters.[61]

Another proposal was to permit the applicant exchange to elect whether to introduce the product as a security solely under the SEC jurisdiction or a futures contract solely under CFTC jurisdiction.[62] Proponents of this option argued that it would remove legal uncertainty about the new product, avoid litigation and promote incentives for responsible innovation and fair competition.[63]

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56 *See* Brodsky Testimony, *supra* note 52.

57 *See* Leibowitz Testimony, *supra* note 51; and Nasdaq Comment Letter, *supra* note 51.

58 *See* MOU, s*upra* note 12.

59 *See* Brodsky Testimony, *supra* note 52; Donohue Testimony, *supra* note 51; Leibowitz Testimony, *supra* note 51; Testimony of Wayne Luthringshausen, Chairman of the Board and Chief Executive Officer, The Options Clearing Corporation, September 2, 2009 ("Luthringshausen Testimony"); Raisler Testimony, *supra* note 52; Reitz Testimony, *supra* note 51; Testimony of Damon Silvers, Associate General Counsel, AFL-CIO, September 3, 2009 ("Silvers Testimony"); *see also* letter from John Damgard, President, Futures Industry Association, to Elizabeth M. Murphy, Secretary, SEC, and David Stawick, Secretary, CFTC, dated September 14, 2009 ("FIA Comment Letter"); Options Exchanges Comment Letter, *supra* note 52; and SIFMA Comment Letter, *supra* note 52.

60 *See* Leibowitz Testimony, *supra* note 51.

61 *See* Brodsky Testimony, *supra* note 52; and Luthringshausen Testimony, *supra* note 59.

62 *See* Donohue Testimony, *supra* note 51; and FIA Comment Letter, *supra* note 59.

63 *See* FIA Comment Letter, *supra* note 59.

B. Review and Approval of Rules

1. SEC Regulatory Framework

Pursuant to Section 19(b)(1) of the Securities Exchange Act, each SRO must file any proposed change in, addition to, or deletion from the rules of the exchange electronically on a Form 19b-4, submitted to the SEC through the Electronic Form 19b-4 Filing System, which is a secure web-site operated by the SEC.[64]

Once filed, the SEC must publish a notice of the filing in the Federal Register, which notice must include the SRO's description of the terms of substance of the proposed change, the purpose of the proposal, and the statutory basis for the proposal, and give the public an opportunity to submit comments on the proposed rule change.[65] If the proposed rule change was filed pursuant to Section 19(b)(2) of the Securities Exchange Act, the SEC must, within 35 days of publication of the notice, approve the proposed rule change by order or institute proceedings to determine whether the proposed rule change should be disapproved.[66] The SEC can extend this time up to 90 days if it finds such longer period to be appropriate and publishes its reasons therefore or may receive consent from the exchange to extend the 35 day period. After publication, if comment letters raise significant issues, SEC staff may request that the exchange respond to comments by submitting a comment letter or amending the proposal. The SEC must approve a proposed rule change if it finds that the proposed rule change is consistent with the requirements of the Securities Exchange Act and the rules and regulations thereunder applicable to the SRO. If the Commission cannot make such a finding, it must disapprove the proposed rule change. In addition, whenever the Commission is engaged in reviewing an SRO rule and is required to consider or determine whether an action is necessary or appropriate in the public interest, the Commission shall also consider, in addition to the protection of investors, whether the action will promote efficiency, competition and capital formation.[67]

There are certain proposed rule changes that may be filed under Section 19(b)(3)(A) of the Securities Exchange Act and take effect upon filing (*i.e.*, without need for specific SEC approval).[68] The proposed rule changes that may take effect upon filing

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64 15 U.S.C. 78s(b)(1) and 17 CFR 240.19b-4. The SRO must also post the proposed rule change and any amendments to it on its web-site. *See* Rule 19b-4(l). 17 CFR 240.19b-4(l).

65 15 U.S.C. 78s(b)(1). SEC staff must issue notices of all proposed rule changes within 15 business days of filing thereof by the exchange unless the Director of the Division of Trading and Markets personally directs otherwise. If the Director has so directed, he must promptly notify the Commission and either the Commission or the Director may order publication of the notice thereafter. *See* Rule 200.30-3(a)(12), 17 CFR 200.30-3(a)(12). *See also* Securities Exchange Act Release No. 58092, 73 FR 40144 (July 11, 2008) ("Streamlining Release").

66 15 U.S.C. 78s(b)(2).

67 Section 3(f) of the Securities Exchange Act, 15 U.S.C. 78c(f).

68 The Commission has the authority to abrogate any proposed rule change submitted as effective upon filing. *See* Section 19(b)(3)(A) of the Securities Exchange Act and further discussion below. 15 U.S.C. 78s(b)(3)(A).

under this section of the Securities Exchange Act include: (i) those that constitute a stated policy, practice or interpretation with respect to the enforcement of an existing rule of the SRO;[69] (ii) those that establish or change a due, fee, or other charge imposed by the SRO;[70] and (iii) those that are concerned solely with the administration of the SRO.[71]

In addition, pursuant to its authority under Section 19(b)(3)(A) of the Securities Exchange Act, the SEC adopted Rule 19b-4(f) to expand the types of proposed rule changes that may become effective upon filing. Specifically, an SRO may file a proposed rule change that is effective upon filing if the proposal effects a change to an existing order entry or trading system that (i) does not significantly affect the protection of investors or the public interest; (ii) does not impose a significant burden on competition; and (iii) does not have the effect of limiting the access or availability of the system.[72] In addition, Rule 19b-4(f)(6) permits exchanges to file "non-controversial" changes to their rules that may take effect upon filing so long as they (i) do not significantly affect the protection of investors or the public interest; (ii) do not impose any significant burden on competition; and (iii) do not become operative for 30 days after the date of filing and the exchange has given written notice of the proposal, including a brief description and rule text, at least five business days prior to filing.[73]

Although rule changes filed under Section 19(b)(3)(A) are immediately effective, the SEC still publishes them for notice and comment. The Commission may abrogate the rule within 60 days of the date of filing if necessary or appropriate in the public interest, for the protection of investors, or otherwise in furtherance of the purposes of the Securities Exchange Act.[74] A rule abrogated by the Commission may be re-filed by the SRO for review and publication under the regular notice and comment process, described above.

In July last year, the SEC issued a Streamlining Release, which was intended, among other things, to increase the number of rule proposals that could be submitted for immediate effectiveness.[75] Since the effective date of the Streamlining release in July last year to September 9, 2009, the Commission received 1,484 proposed rule changes.

Of those, 1,403 filings were submitted by national securities exchanges, the Financial Industry Regulatory Authority ("FINRA"), the Municipal Securities

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69 *See* Section 19(b)(3)(A)(i) of the Securities Exchange Act, 15 U.S.C. 78s(b)(3)(A)(i).

70 15 U.S.C. 78s(b)(3)(A)(ii). This provision only applies to dues, fees or other charges imposed on members of the exchange. *See* Rule 19b-4(f)(2). 17 CFR 240.19b-4(f)(2).

71 *See* Section 19(b)(3)(A)(iii) of the Securities Exchange Act, 15 U.S.C. 78s(b)(3)(A)(1).

72 Rule 19b-4(f)(5), 17 CFR 240.19b-4(f)(5).

73 Rule 19b-4(f)(6), 17 CFR 240.19b-4(f)(6).

74 15 U.S.C. 78s(b)(3)(C).

75 *See* Streamlining Release, *supra* note 65.

Rulemaking Board ("MSRB"), and notice-registered securities futures exchanges.[76] Among those filings:

- 68% were submitted for immediate effectiveness under Section 19(b)(3)(A).
- 32% were submitted "regular way" under Section 19(b)(2).

On average, for closed filings, the SEC published proposed rule changes within 5.5 business days (4 business days median) from the date of filing.[77] On average, for closed filings, the SEC approved filings submitted under Section 19(b)(2) within 30 calendar days (34 days median) from publication.

2. CFTC Regulatory Framework

Rules and rule amendments by registered entities, including not only DCMs but derivatives clearing organizations ("DCOs") and exempt commercial markets ("ECMs") with significant price discovery contracts, are governed generally by the same statutory authority that addresses product filings by DCMs.[78] Registered entities must submit all new rules and amendments either through self-certification or with a request for approval.

In self certifying a rule or rule amendment, the registered entity's submission must include: (i) a brief explanation of any substantive opposing views of its governing board, board committee members or market participants; and (ii) a certification that the rule complies with the CEA and the CFTC's regulations. The submission must be filed with the CFTC no later than the opening of business on the CFTC's business day preceding the CFTC business day of the initial implementation of the rule.[79]

As with the product self-certification procedures, self-certification of a rule or rule amendment does not extinguish the CFTC's review authority. Upon receipt of a rule self-certification that has a material consequence, for example, the CFTC reviews the proposal, even if the new rule may be in effect while that review is underway. The CFTC also generally engages in ongoing dialogue with exchanges, and it may require a registered entity to address concerns regarding a new rule or rule amendment by filing information demonstrating how it is in compliance with one or more of the designation criteria or core principles.[80] Exchanges also may elect to seek CFTC approval of a rule or rule amendment.

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[76] The remaining filings were submitted by clearing agencies.

[77] This figure excludes twenty filings (1.4%) held beyond 15 days for additional review. As contemplated by the Streamlining Release, certain proposed rule changes involve novel issues that require additional analysis and consultation. Such filings may be withheld from notice beyond 15 business days.

[78] *See* CEA Section 5c(c), 7 U.S.C. 7a-2(c).

[79] CFTC Regulation 40.6, 17 CFR 40.6.

[80] CFTC Regulation 38.5(b), 17 CFR 38.5(b).

Notwithstanding these procedures and practices, as with products, the CFTC's role in rule approval is circumscribed. For example, the CFTC must approve the submitted rule or rule amendment unless it finds that it "would violate" the CEA.[81]

The CFTC does have the authority to alter or supplement the rules of a registered entity after a determination that a modification would be necessary to protect the markets and market participants, after notice and opportunity for a hearing.[82] The CFTC may direct a registered entity, whenever it has reason to believe that an emergency exists, to take such action as is necessary to maintain or restore orderly trading in, or liquidation of, any futures contract.[83]

3. Analysis of SEC/CFTC Regulatory Frameworks

There are basic differences in the regimes under which the CFTC and SEC approve and review rule changes for exchanges and clearinghouses. Under the CEA's principles-based approach to oversight, rule filings are mostly made under self-certification procedures. To take formal action and to disapprove a self-certified rule, the CFTC must determine that a rule violates the CEA.[84] This approach lessens the authority of the regulatory agency to review proposed rules. Exchanges state that the self-certification process is competitively important because it allows them to implement rule changes very quickly. [85]

Under the Securities Exchange Act, although exchanges must submit proposed rule changes to the agency, about two-thirds of proposed rule changes are effective immediately upon filing. The remaining rule changes, however, in contrast to the approach under the CEA, must be approved by the SEC before they are effective. All proposed rule changes are published for comment, which permits the public to comment. Public comments identify aspects of proposed rule changes that are potentially unfair or anticompetitive, or that would have unanticipated practical consequences.

The panelists and commentators offered mixed views of both of the SEC's and CFTC's regulatory approaches. Exchanges and clearinghouses generally indicated a preference for the self-certification of rules on the ground that the approach creates an appropriate balance between enabling exchanges (and clearinghouses) to implement business decisions promptly and permitting the regulatory agency to focus on proposals that present significant regulatory issues.[86] Some of these panelists emphasized that the

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81 CEA Section 5c(c)(3), 7 U.S.C. 7a-2(c)(3).

82 CEA Section 8a(7), 7 U.S.C. 12a(7).

83 CEA Section 8a(9), 7 U.S.C. 12a(9).

84 CEA Section 5c(c)(3).

85 *See* Brodsky Testimony, *supra* note 52; Leibowitz Testimony, *supra* note 51; Options Exchanges Comment Letter, *supra* note 52; Nasdaq Comment Letter, *supra* note 51; *see also* Brown-Hruska Testimony, *supra* note 54.

86 *See e.g.*, Brodsky Testimony, *supra* note 52; Leibowitz Testimony, *supra* note 51; *see also* Options Exchanges Comment Letter, *supra* note 52; Nasdaq Comment Letter, *supra* note 51.

delays attendant to a prior approval regime caused significant domestic and international competitive disadvantages.[87] Some speakers also complained that a prior approval process could subject exchanges, clearinghouses, and SROs to arbitrary decision-making by staff.[88]

Other speakers, however, observed that the pre-approval approach under the securities laws, among other things, has the virtue of creating legal certainty for the regulated entity.[89] One commentator emphasized this issue with respect to SRO rules governing the conduct of SRO members, since such rules have a significant impact on member business conduct and provide for disciplinary actions for noncompliance.[90] Accordingly, some commentators stated that it is important that there be notice and comment on significant rules governing the conduct of business and discipline of SRO members, and that the agencies take an active role in the approval of these SRO rules before they become effective.[91]

Although some panelists and commentators demonstrated preference for one regime or the other, most stated that the agencies' oversight of exchange and clearinghouse rules should be governed by a set of overarching principles that balance the enhanced legal certainty and opportunity to comment of prior approval with the expedition provided by self-certification.[92] These panelists stated that each approach advanced important public policy goals for the two markets.[93]

Some panelists suggested that the SEC could move more toward principles-based regulation and more rapid approval of exchange rules.[94] They advocated, for example, that the SEC increase the number of rules or products that are eligible for the "effective

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87 *See e.g.*, Brodsky Testimony, *supra* note 52; *see also* Options Exchanges Comment Letter, *supra* note 52.

88 *Id*.

89 *See* Leibowitz Testimony, *supra* note 51.

90 *See* SIFMA Comment Letter, *supra* note 52. *See also* FIA Comment Letter, *supra* note 59, stating "FIA believes that before SRO rules are imposed on market participants some public process, including a 30 day notice and comment period, should be afforded to interested parties. FIA believes this transparent process should allow for expeditious action by the relevant Commission on the proposed SRO rules."

91 *See, e.g.*, SIFMA Comment Letter, *supra* note 52.

92 *See, e.g.*, Leibowitz Testimony, *supra* note 51.

93 One panelist stated that these principles should be comparable to and consistent with the International Organization for Securities Commissions (IOSCO) principles for securities regulation and screen-based trading to ensure a more consistent alignment of regulation across global markets. *See* Leibowitz Testimony, *supra* note 51; *see also* Testimony of Johnathan Short, Senior Vice President and General Counsel, Intercontinental Exchange, Inc., September 2, 2009 ("Short Testimony").

94 *See e.g.*, Brodsky Testimony, *supra* note 52 and Brown-Hruska Testimony, *supra* note 54; *see also* Leibowitz Testimony, *supra* note 51 (recommending for the SEC a certification regime similar to the CFTC).

on filing" status.[95] Quoting the Treasury White Paper, those panelists proposed that "[t]he SEC should recommend requirements to respond more expeditiously to proposals for new products and SRO rule changes and should recommend expansion of the types of filings that should be deemed effective upon filing."[96] Those commentators who advocated for the self-certification model generally, though not exclusively, focused on rule changes involved in listing a new product.[97] Other speakers acknowledged, however, that in many contexts policy objectives such as speed, which may be advanced by a self-certification model, should be tempered by a more deliberative process that would permit the regulator to properly assess the proposal, particularly with respect to rules (or products) that may have significant competitive and other public effects.

In the same vein, it was suggested that, if there is to be convergence in overarching rules governing exchange and clearinghouse oversight by the agencies, those rules should be much more precise than the core principles in the CEA.[98] In addition, it was stated that the CFTC standard of review for rule filings – that the rule shall be approved unless it "would violate" the CEA – did not afford the agency sufficient authority to address potentially problematic certification filings.

C. Financial Responsibility: Segregation, Insolvency and Margin

The securities and futures regulatory regimes administered by the SEC and CFTC, respectively, both strive to promote a system that protects customers' funds and facilitates efficient and sound markets. However, there are distinct differences in the SEC's and CFTC's approaches to segregation of customer funds, insolvency and margin, which are based, in part, on the legal frameworks established for their respective markets and the nature of the products that are traded in those markets. Discussed below are the current SEC and CFTC approaches with respect to these financial responsibility matters.

1. SEC Regulatory Framework

Segregation and Insolvency

A broker-dealer conducting a general securities business that is required to register with the SEC under Section 15(b) of the Securities Exchange Act[99] must comply withthe SEC's net capital rule. Broker-dealers are subject to the SEC's net capital rule under Section 15(c)(3) of the Securities Exchange Act.[100]

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95 *See, e.g.,* Leibowitz Testimony, *supra* note 51.

96 *See* Donohue Testimony, *supra* note 51.

97 *See, e.g.,* Raisler Testimony, *supra* note 52; FIA Comment Letter, *supra* note 59; and SIFMA Comment Letter, *supra* note 52.

98 *See* SIFMA Comment Letter, *supra* note 52, citing the Treasury White Paper, *supra* note 1, at 50.

99 15 U.S.C. 78o(b).

100 15 U.S.C. 78o(c)(3); and 17 CFR 240.15c3-1.

Under Section 15(c)(3) of the Securities Exchange Act, the SEC may prescribe rules and regulations "to provide safeguards with respect to the financial responsibility and related practices of broker and dealers, including, but not limited to, the acceptance of custody and use of customers' securities and the carrying and use of customers' deposits or credit balances."[101] The primary purpose of the net capital rule – Rule 15c3-1[102] – is to protect the customers and creditors of registered broker-dealers from monetary losses and delays that can occur when a registered broker-dealer fails. With sufficient net capital, a broker-dealer can liquidate in an orderly manner without the need for a formal Securities Investor Protection Corporation ("SIPC") liquidation.

A broker-dealer required to register with SEC must comply with the SEC's customer protection rule – Securities Exchange Act Rule 15c3-3.[103] Under this rule, a broker-dealer must, in essence, segregate customer funds and fully paid and excess margin securities held by the firm for the accounts of customers. The intent of the rule is to require a broker-dealer to hold customer assets in a manner that enables their prompt return in the event of an insolvency, which, in turn, increases the ability of the firm to wind down in an orderly self-liquidation and thereby avoid the need for a proceeding under the SIPA.[104] The SEC adopted Rule 15c3-3 in response to the Paperwork Crisis of 1968-1971, when, unable to handle the increased trading volume of the time, broker-dealers' bookkeeping was commonly inaccurate due to a lack of automation, which led to the misplacement and misappropriation of customer funds and securities. Congress was also concerned that customer funds and funds obtained from the use of customer securities were being used to finance the speculative activities of broker-dealers, therefore exposing customers to unwarranted risk of loss. In response to these concerns, Congress enacted SIPA which amended Section 15(c)(3) of the Securities Exchange Act[105] to direct the Commission to establish rules to "provide safeguards with respect to financial responsibility [of broker-dealers], [i]ncluding…the acceptance and use of customer funds and securities and the carrying and use of customers' deposits or credit balances. Subsequently, in 1972, the SEC adopted Rule 15c3-3.[106]

Rule 15c3-3, as part of the SEC's financial responsibility rules, safeguards and restricts the use of customer assets by the broker-dealer in its business activities in two ways. The rule protects customer funds, by requiring, in accordance with a prescribed formula, the broker-dealer to deposit into a separate bank account the net amount of funds derived from customer activities. In addition, the rule requires the broker-dealer to obtain possession or control of a customer's fully paid and excess margin securities. These requirements are described in detail below.

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101 *Id.*

102 17 CFR 240.15c3-1.

103 17 CFR 240.15c3-3.

104 15 U.S.C. 78aaa *et seq*.

105 15 U.S.C. 78o(c)(3).

106 *See* Securities Exchange Act Release No. 9856 (November 10, 1972), 37 FR 25224 (November 29, 1972).

Rule 15c3-3 also requires a broker-dealer to maintain physical possession or control of all fully paid and excess margin securities carried for customers. This means the broker-dealer cannot lend or hypothecate these securities and must hold them itself or, as is more common, in a satisfactory control location.

Moreover, a broker-dealer cannot: commingle the securities of different customers as collateral for a loan without the consent of each customer; commingle its own securities with those of its customers; and pledge its customers' securities in an amount exceeding the amount the customers owe the broker-dealer.[107]

Margin Requirements

Pursuant to Section 7(a) of the Securities Exchange Act,[108] Congress delegated the sole authority to set margin levels with respect to stock to the Board of Governors of the Federal Reserve System("FRB"). It is significant to note that Congress's delegation of margin authority to the FRB arose in the aftermath of the 1929 stock market crash and reflects Congress's conclusion that "the trading of securities on credit could lead to significant problems in financial markets and the economy more generally."[109] As discussed in more detail below, the FRB generally sets initial margin requirements, while SROs generally set maintenance margin levels (through rule filings with the SEC).

The FRB promulgated regulations for initial margin *only* in Regulation T.[110] Regulation T regulates securities credit extended by broker-dealers to their customers by establishing "accounts" in which securities transactions may be effected and/or financed. Different requirements apply to each type of account. There are presently five Regulation T accounts—the margin account, the special memorandum account, the good faith account, the cash account, and the broker-dealer credit account.[111]

The margin account rules of Regulation T only specify an *initial* margin requirement and limit withdrawals and substitutions of cash and collateral; they do not require the maintenance of margin levels to reflect changes in market values of collateral.

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107 SEC Rule 8c-1, 17 CFR 240.8c-1.

108 15 U.S.C. 78g(a).

109 Staff of the Board of Governors of the Federal Reserve, a Review and Valuation of Federal Margin Regulations (1984).

110 12 CFR 220.1–220.12.

111 Any transaction not specifically permitted in a special purpose account must be recorded in a margin account. 12 CFR 220.4. Cash accounts are designed to accommodate customer purchase and sales on a noncredit basis. 12 CFR 220.8 The special memorandum account (or SMA) supplements a customer's margin account to preserve buying power in the customer's margin account by reflecting any excess equity in the margin account that is above the required amount (*e.g.* 50% for marginable securities). 12 CFR 220.5. The broker-dealer credit account allows a broker-dealer to extend certain types of credit to another broker-dealer (DVP/RVP, omnibus credit). 12 CFR 220.7. A good faith account permits a broker-dealer to effect and finance a wide range of transactions in good faith margin securities without the restrictions of the cash or margin account. 12 CFR 220.6.

Regulation T margin account rules also cover other credit-based securities transactions, such as short sales and the writing of options. The SEC enforces Regulation T with respect to broker-dealers.

SRO rules set maintenance margin rules for securities transactions for broker-dealers.[112] In addition, SRO rules may act as a supplement to Regulation T. In this regard, SRO margin rules generally, among other things: (1) provide maintenance requirements with respect to customer margin accounts; (2) establish specific margin requirements on securities transactions and positions which require only good faith margin under Regulation T; (3) provide that certain cash account transactions will be treated as margin transactions; (4) regulate margin to be maintained on positions in "control" and "restricted" securities under the Securities Act; and (5) specify margin requirements for the writing of put and call options. SRO margin requirements for similar securities products are generally similar across exchanges.

SRO margin rules generally are based on specific percentages or strategies for each position held in a margin account. The SEC has also approved SRO rules for risk-based portfolio margin for equity-based products (because of an exception in Regulation T). See the next section for a description of portfolio margining.

With respect to options margin, initial and maintenance margin requirements are generally set by the exchanges and SROs.[113] Generally, Buyers of (long) options must pay for these positions in full. However, a customer can generally buy equity options and equity index options on margin, provided the option has more than nine (9) months until expiration. For example, the initial (maintenance) margin requirement is generally 75% of the cost (market value) of a listed, long term equity or equity index put or call option. A buyer of a "long" position in a non-marginable put option or call option is required to pay the premium amount in full. Margin requirements for option writers are complex and are not the same for every type of underlying interest. SRO rules generally require an option writer to post 100% of the options proceeds to the margin account, plus a specific percentage of the market value of the underlying securities as options margin (e.g., 20% for an equity option). SRO rules also recognize certain spread positions. Finally, equity-based options are also eligible positions under the SRO securities portfolio margin described below.

With respect to SFPs, the CFMA added Subsection 2(a)(1)(D)(i)(XI) to the CEA[114] and Subsection 7(c)(2) to the Securities Exchange Act.[115] These provisions direct the FRB to prescribe regulations establishing initial and maintenance customer margin requirements subject to certain statutory standards. This authority was delegated

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112 *See* NYSE Rule 431 and NASD Rule 2520 – which are presently part of the FINRA rulebook.

113 *See* 12 CFR 220.12(f).

114 7 U.S.C. 2(a)(1)(D)(i)(XI).

115 15 U.S.C. 78g(c)(2).

to the CFTC and the SEC, and the agencies issued joint customer margin regulations that became effective September 13, 2002.[116]

Portfolio Margining

As part of the 1997 amendments to Regulation T, the FRB adopted new Section 220.1(b)(3)(i) in Regulation T,[117] excluding from the scope of Regulation T "[f]inancial relations between a customer and a creditor to the extent that they comply with a portfolio margining system under rules approved or amended by the SEC."

The SEC has approved portfolio margining for positions held in a securities account for equities, securities options, equity-based OTC derivatives, single stock futures, and broad-based index futures.[118] These pilot programs were made permanent in 2008.[119]

The SRO portfolio margin rules permit futures positions (that are not securities) to be held in a portfolio margin securities account together with securities positions. This is often referred to as the "one pot approach."

Under the SRO portfolio margin rules,[120] firms must compute margin using a method approved by the SEC. Currently, the only approved theoretical pricing model is the Options Clearing Corporation's ("OCC") Theoretical Intermarket Margin System ("TIMS") model.[121] TIMS considers movements for all instruments based on an underlying equity (in TIMS a "portfolio" consists of all positions, including options, futures and stock, referencing the same underlier) across a range of 30 percent, by moving 15 percent up from the current market price and down 15 percent from the current market price. Broad-based indices are moved 6 percent up and 8 percent down. At 10 points equally spaced within the relevant range, the profit and loss on all positions in the same underlier is computed. The margin requirement is determined by simply summing the losses resulting from the most adverse event for each underlier. TIMS does not recognize offsets across individual equity portfolios. Offsets between certain broad-based indices are recognized.

2. CFTC Regulatory Framework

Segregation, Insolvency and Margin Requirements

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116 17 CFR 41.42 through 41.49; 17 CFR 240.400 through 406; *see also* Securities Exchange Act Release No. 46292 (August 1, 2002), 67 FR 53146 (August 14, 2002).

117 12 CFR 220.1(b)(e)(i).

118 *See* NYSE Rule 431(g) and NASD Rule 2520(g).

119 *See* Securities Exchange Act Release No. 58251 (July 30, 2008), 73 FR 45506 (August 5, 2008).

120 *See supra* note 118.

121 *See* Securities Exchange Act Release No. 28928 (March 1, 1991), 56 FR 9995 (March 8, 1991).

In the futures markets, "margin" refers to the performance bond posted by both the buyer (long) and seller (short) against loss on an open futures contract. "Clearing margin," which is paid by an FCM to a clearinghouse, is set by the clearinghouse, and "customer margin," which is paid by a customer to its FCM, is set by the exchange on which a particular contract is traded. The exchange minimum is based on the level set by the clearinghouse (typically about 30 percent higher than the clearing margin), although an FCM may set a level higher than the minimum for any or all of its customers.

The CFTC does not have general authority to set margin levels for futures contracts or options on futures. However, by way of its oversight responsibility for DCO financial resources and DCO risk surveillance, the agency monitors and oversees clearing margin levels to ensure adequate performance bond coverage for all contracts.[122] The CFTC has authority to set margin levels on any futures contract in the exercise of its emergency authority.[123] The CEA confers upon the FRB authority to review margin on broad-based stock index futures and options thereon.[124] The FRB has delegated this authority to the CFTC.[125] Therefore, exchanges that trade such contracts are required to file with the CFTC any rule establishing or changing the levels of initial or maintenance margin.

Under the CEA, an FCM must at all times possess segregated property sufficient to pay all customers with credit balances.[126] To the extent any customers have debit balances, the FCM must deposit that amount out of its own capital. Each FCM must perform an accounting every business day based on balances as of the close of business on the previous business day. If an FCM, at any time, fails to have sufficient segregated property, it must self-report that violation.[127] As a practical matter, all FCMs maintain a cushion of their own funds in segregation to avoid such failures. In a FCM bankruptcy, customers share customer property pro rata in proportion to their claims, without any support from a compensation fund.[128] Such possession and control of full collateral facilitates prompt transfer of customer funds in bankruptcies, such as the case of Lehman Brothers, to avoid market disruption.[129]

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122 Core Principle B, CEA Section 5b(c)(2)(B), 7 U.S.C. 7a-1(c)(2)(B); Core Principle D, CEA Section 5b(c)(2)(D), 7 U.S.C. 7a-1(c)(2)(D).

123 CEA Section 8a(9), 7 U.S.C. 12a(9).

124 CEA Section 2(a)(1)(C)(v) , 7 U.S.C. 2(a)(1)(C)(v).

125 Letter dated April 14, 1993 from William W. Wiles, Secretary of the Board, Board of Governors of the Federal Reserve System to William P. Albrecht, Acting Chairman, Commodity Futures Trading Commission.

126 Section 4d(a)(2), 7 U.S.C. 6d(a)(2).

127 17 CFR 1.12(h).

128 Customers do, however, receive a priority in bankruptcy to customer property over other unsecured claims, other than certain administrative expenses of the debtor FCM's estate. *See* 11 U.S.C. 766(h).

129 The Bankruptcy Code and CFTC regulations provide explicit protection against attack by the trustee in bankruptcy of pre-bankruptcy and certain post- bankruptcy transfers in a bankruptcy case. *See* 11 U.S.C. 764(b); 17 CFR 190.06(g)(i). *See also* 11 U.S.C. 546(e).

Portfolio Margining

"Risk-based portfolio margining" generally refers to a margin methodology that sets a minimum level of required margin by analyzing the risk of each component position in an account and then recognizing any risk offsets in the overall portfolio of positions. For futures contracts, the minimum margin amount is calculated using a risk-based analysis and is designed to cover the expected one-day price change of an open position in that contract with an established level of statistical confidence (generally 95-99%). The one-day time frame reflects the fact that futures positions are marked to market at least once a day.

Minimum margin levels for futures contracts, except for SFPs, are generally calculated using the Standard Portfolio Analysis of Risk ("SPAN") risk-based portfolio margining methodology. The margin requirement for a portfolio that may contain positions in different futures and/or options contracts is similarly calculated by using a risk-based portfolio margining system that assesses the net market risk of all the positions in the account. The calculation is based upon the premise that combinations of positions can have offsetting risk characteristics due to historic or expected correlations in their price movements.

The SRO securities portfolio margining program facilitated by NYSE Rule 431(g) and National Association of Securities Dealers ("NASD") Rule 2520(g) has a cross-margining component that would permit margin reductions between securities and broad-based index futures products held in a securities portfolio margin account. Because the CEA requires segregation of futures positions, futures options positions, and customer property related to those positions, absent a waiver of these CFTC segregation requirements, such positions and property can be held only in a futures account, absent a CFTC exemption.[130]

As noted above, the CEA and the Securities Exchange Act govern margin for SFPs.[131] The statutes authorize the FRB to prescribe regulations establishing initial and maintenance customer margin, but the FRB delegated rulemaking authority to the CFTC and the SEC. In its delegation letter of March 6, 2001, the FRB stated its support of "more risk-sensitive, portfolio-based approaches to margining security futures products."[132] Pursuant to this authority, the CFTC and SEC issued joint customer margin regulations that became effective September 13, 2002.[133]

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130 CEA Section 4d, 7 U.S.C. 6d.

131 *See supra* notes 114 and 115 and accompanying text.

132 Under the Securities Exchange Act, margin for SFPs cannot be lower than the lowest level permitted for a comparable security option. *See* Securities Exchange Act Section 7(c)(2)(B)(iii)(I), 15 U.S.C. 78g(c)(2)(B)(iii)(I). As a result, the 2002 CFTC-SEC joint margin regulations for SFPs establish a fixed-rate customer performance bond requirement of 20%, with margin reductions permitted for specified combinations of positions. More recently, Section 13106 of the CFTC Reauthorization Act of 2008, Title XIII of Pub. L. No. 110-246, 112 Stat. 2189 (2008), required the SEC and the CFTC to take action to permit "risk-based portfolio

3. Analysis of SEC/CFTC Regulatory Frameworks

Approaches to Segregation and Insolvency

Under the CEA and the federal securities laws, both broker-dealers and FCMs are subject to restrictions when handling customer funds and property. These "segregation" rules aim to protect customers from inappropriate use of customer funds by FCMs and broker-dealers. Although CFTC and SEC regulations provide detailed requirements regarding the segregation of customer assets, their governing statutory regimes provide for certain significant differences in the specific manner in which assets are segregated.

Section 4d(a)(2) of the CEA requires that an FCM "treat and deal with all customer funds as belonging to such customer" and not to any other person.[134] Thus, an FCM must collect required margin from each customer to cover the margin or obligations only of such customer and is not permitted to use one customer's funds to cover the obligations of another. SEC Rule 15c3-3[135] prohibits a broker-dealer from commingling its own securities with those of its customers or pledging its customers' securities in an amount exceeding the amount the customer owes the broker-dealer. If a customer has an outstanding margin loan from his broker-dealer, the broker-dealer is permitted to use a limited percent of that customer's securities for financing. However, a broker-dealer may not use one customer's fully paid securities as collateral for a loan to another customer. In contrast, the ability to finance customer securities positions has no analog in the futures regulatory framework because futures are not assets against which loans may be extended. Finally, under the CFTC's regulations, FCM's are permitted to invest segregated customer funds, subject to certain limitations, in permissible investments, including certain money market funds. The funds that broker-dealers are required to segregate for customers must be held either in cash or Treasury securities.

With regard to bankruptcy, a broker-dealer is generally liquidated in accordance with the provisions of SIPA,[136] while an FCM is liquidated in accordance with the provisions of Subchapter IV of Chapter 7 of the Bankruptcy Code.[137] These regimes

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margining" for security options and SFPs by September 30, 2009. The CFTC and SEC staffs are currently working on a Notice of Proposed Rulemaking that would propose a reduction of minimum customer margin for SFPs from 20% to 15% for positions that are not held in a securities portfolio margin account. This would mean that minimum margin for unhedged positions held in a regular securities account or a futures account, would be 15%.

133 *See supra* note 116.

134 7 U.S.C. 6d(a)(2).

135 17 CFR 240.15c3-3.

136 *See supra* note 104 and accompanying text.

137 11 U.S.C. Chapter 7, Subchapter IV. For broker-dealers, in a SIPC liquidation, except where SIPA is inconsistent, SIPA provides that a broker-dealer liquidation is conducted under chapters 1, 3 and 5 and subchapters I and II of chapter 7 of title 11 of the Bankruptcy Code. SIPA Section

governing bankruptcy and insolvency for broker-dealers and FCMs both provide that customers have priority status over unsecured creditors (with the exception of certain unsecured estate administration claims) and that, in the event an insolvent firm is unable to return all customer property, the impact of the shortfall is shared pro rata among customers. However, these two regimes are not uniform and the procedures to be followed in the event of the insolvency of a broker-dealer or FCM differ. For example, securities are protected by an additional $500,000 per customer under SIPA, which is a protection that futures accounts do not have. Instead, coupled with the strict segregation rules, the Bankruptcy Code and CFTC regulations contemplate portability, whereby customers may transfer their positions and accounts expeditiously from an insolvent FCM to a financially healthy FCM, if feasible.[138] SEC regulations also contemplate expeditious transfer of customer accounts through self-liquidation or a proceeding under SIPA. In general, if the books and records of the broker-dealer are in order and customer accounts are properly margined, customer accounts may be transferred to another broker-dealer in a process known as a bulk transfer.

In noting these issues, panelists asked the agencies to consider whether such differences in the bankruptcy/insolvency regimes should persist, particularly as related to insolvency treatment for an entity that is both a broker-dealer and a FCM.[139] Panelists observed that these differences were highlighted when Lehman Brothers Inc.—a jointly regulated BD/FCM—filed for bankruptcy.[140] They noted that as more OTC derivatives come onto exchanges and clearinghouses, it would be important to develop and implement a more uniform customer account regime that protects both customer assets and the integrity of the market in the event of a default of a major firm.[141] According to panelists, in the absence of amendments to the Bankruptcy Code relating to the liquidation of stockbrokers and commodity brokers, the SEC and CFTC should develop procedures to guide a trustee, as well as the Bankruptcy Court, when a joint BD/FCM becomes insolvent.[142]

Setting Margin

6(b), 15 U.S.C.78fff(b). In the case of a firm that is a dually-registered broker-dealer/FCM, SIPA provides that, to the extent consistent with SIPA, a SIPA trustee is subject to the duties of a trustee under Subchapter IV of Chapter 7 of the Bankruptcy Code. *See* SIPA Section 7(b), 15 U.S.C. 78fff-1(b).

138 *See* 11 U.S.C. 764(b); CFTC Regulations 1.17(a)(4), 17 CFR 1.17(a)(4); and 190.06(g), 17 CFR 190.06(g).

139 *See* Brodsky Testimony, *supra* note 52 and Testimony of Yvonne Downs, Senior Director, Newedge USA LLC, September 2, 2009 ("Downs Testimony"); *see also* FIA Comment Letter, *supra* note 59 and Options Exchanges Comment Letter, *supra* note 52.

140 *See* Leibowitz Testimony, *supra* note 51 and Testimony of Anthony J. Leitner, AJ Leitner and Associates, LLC, September 2, 2009 ("Leitner Testimony").

141 *See* Leibowitz Testimony, *supra* note 51; *see generally* Leitner Testimony, *supra* note 140, Testimony of Annette Nazareth, Partner, Davis Polk & Wardwell, LLP, September 2, 2009 ("Nazareth Testimony"), and FIA Comment Letter, *supra* note 59.

142 *See* Leibowitz Testimony, *supra* note 51 and FIA Comment Letter, *supra* note 59.

Broker-dealers and FCMs collect margin from their customers to address the risks arising from their intermediation of customer transactions. In the securities markets, minimum customer margin requirements have been established for cash and derivative securities positions. In the futures markets, minimum customer margin or performance bond requirements have been established for the derivative positions. Differences between the methodology for calculating margin requirements in the cash securities and the methodologies used in the options securities and futures markets reflect differences between cash and derivatives markets. In futures markets, margin is a performance bond to satisfy the performance of both parties to a futures contract. A performance bond deposit is not partial payment on a purchase, nor does it involve an extension of credit by an FCM. Similarly, in securities options markets, margin is a performance bond to satisfy the performance obligations of the option seller.

In cash securities markets, margin generally is viewed as the extension of credit by a broker-dealer to purchase such securities, using the securities as collateral. Further, if a customer is unable to satisfy a margin call, the broker-dealer must sell the customer's securities to satisfy the margin loan.

Given that margin serves different functions in the futures and securities options markets than in the cash securities markets, margin requirements are calculated using different approaches. In the cash securities and securities options markets, customer margin rules have been set by the FRB and the SROs since the 1930s. The requirement that an SRO file proposed margin rules with the SEC has helped ensure that SROs do not compete on the basis of different margin requirements and that margin levels are set at sufficiently prudent levels to reduce systemic risk and protect the solvency of broker-dealers. This approach has generally resulted in similar margin requirements for each securities exchange. With respect to securities options, the FRB and the SROs have developed different approaches for minimum customer margin requirements for cash securities markets than for securities options. Further, Regulation T does not apply to positions held in an approved portfolio margining system.

In contrast, in the futures markets, the clearinghouses set "clearing" margin levels for performance bond paid by clearing FCMs to the clearinghouse, and futures exchanges set higher customer margin levels for performance bond paid by customers to their FCM. The CEA does not provide the CFTC with general authority to set margin levels, and the CFTC does not approve inputs into the risk-based portfolio margin calculation used for futures contracts. However, CFTC staff actively monitors and oversees clearing margin levels to ensure adequate performance bond coverage for all contracts.

Risk-Based Portfolio Margining

Panelists identified portfolio margining as a significant area for harmonization.[143] In particular, they asked for consideration of whether limits on the

[143] *See* Brodsky Testimony, *supra* note 52; Leibowitz Testimony, *supra* note 51; Leitner Testimony, *supra* note 140; Luthringshausen Testimony, *supra* note 59; Downs Testimony, *supra* note 139; Nazareth Testimony, *supra* note 141; Testimony of Edward Rosen, Partner, Cleary, Gottlieb,

types of products that may be cross-margined within a portfolio should be changed.[144] Panelists noted that while securities regulations now allow broker-dealers to establish a portfolio margin account, the instruments that can be included in the account are effectively limited to equity securities and related options.[145] They added that, although the securities regulations technically permit the inclusion of certain index futures in the calculation, the CEA and CFTC regulations preclude the inclusion of futures products in the securities portfolio account. Absent CFTC exemptive relief, it was noted, customers who use futures to hedge risk in their securities positions do not get the full benefit of portfolio margining.[146] Since certain off-shore jurisdictions permit full-fledged portfolio margining, panelists agreed that portfolio margining is important to the international competitiveness of America's financial markets.[147] The ability to margin all related instruments in one account allows customers to more fully realize the risk management potential of these instruments. Portfolio margining also would assist regulators monitor a larger segment of positions in the market as part of their surveillance efforts.

Two general approaches have been advanced regarding how portfolio margining across securities and futures products might be structured: (i) a one account ("one pot") model, which contemplates a single account at the firm level and a set of agreements between the futures and options clearing houses that allow the clearing broker's cross-margining accounts at the futures and securities clearing houses to be margined *as if* they were a single account with jointly held collateral; and (ii) a two account ("two pot") model which, at the clearing firm level, is based on maintenance of a futures account and a securities account that guarantee one another and that, accordingly, receive reductions in the margin calculation. At the clearinghouse level, the two account model is based on

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Steen & Hamilton, LLP, September 2, 2009 ("Rosen Testimony"); Testimony of Lawrence Harris, Professor, USC Marshall School of Business, September 2, 2009 ("Harris Testimony"); Testimony of Brandon Becker, Executive Vice President and Chief Legal Officer, TIAA-CREF, September 2, 2009 ("Becker Testimony"); *see also* Transcript of Oral Testimony of David Downey, Chief Executive Officer, OneChicago, September 2, 2009; Brian Nigito, Managing Director, GETCO LLC, September 2, 2009; and Mark Young, Partner, Kirkland & Ellis, on behalf of the Futures Industry Association, September 2, 2009, *supra* note 3. *See also* letter from Gary DeWaal, Senior Managing Director and Group General Counsel, Newedge USA, LLC, to David Stawick, Secretary, CFTC, and Elizabeth M. Murphy, Secretary, SEC, dated September 14, 2009 ("Newedge Comment Letter"); SIFMA Comment Letter, *supra* note 52; FIA Comment Letter, *supra* note 59 and Options Exchanges Comment Letter, *supra* note 52.

144 *See, e.g.*, Brodsky Testimony, *supra* note 52; Luthringshausen Testimony, *supra* note 59; Nazareth Testimony, *supra* note 141; *see also* SIFMA Comment Letter, *supra* note 52; and Options Exchanges Comment Letter, *supra* note 52.

145 *See, e.g.*, Brodsky Testimony, *supra* note 52; Leitner Testimony, *supra* note 140; Luthringshausen Testimony, *supra* note 59; *see also* FIA Comment Letter, *supra* note 59; and Options Exchanges Comment Letter, *supra* note 52.

146 *See* Brodsky Testimony, *supra* note 52; Leibowitz Testimony, *supra* note 51; Leitner Testimony, *supra* note 140; Luthringshausen Testimony, *supra* note 59.

147 *See* Luthringshausen Testimony, *supra* note 59; Nazareth Testimony, *supra* note 141; Leitner Testimony, *supra* note 140; *see also* SIFMA Comment Letter, *supra* note 52; and Options Exchanges Comment Letter, *supra* note 52.

unsecured cross-guarantees between the two clearinghouses with no common pool of collateral.

Most panelists expressed a preference for the one account model, but noted that it would require legislative and regulatory change. If the financial instruments are to be held in a securities account, SIPA would need to be amended to provide that futures held in a securities portfolio margin account could be covered by SIPC, and the CFTC would need to provide exemptive relief to allow customer futures positions to be held in a securities account.[148] If the single portfolio margin account were a futures account, the SEC and CFTC would need to provide exemptive relief to allow securities to be held in a futures account. Under both alternatives of a one account model, there also would be a question as to what risk-based methodology should be used to determine the margin offsets.

Some panelists observed that, for the short-term, the agencies could consider the model implemented in the joint regulation of SFPs, which allowed certain BDs and FCMs to hold customer SFPs in either a securities account with SIPC protection or a futures account with full segregation safeguards.[149] According to these panelists, such an approach would provide investors with greater choice and control in how their funds are protected, whether it be opting for an insurance regime or maintaining portability of their positions in the event of the intermediary's bankruptcy.

In the long run, however, most panelists agreed that the agencies should create a new unified account regime that adopts the best of both systems and allows for futures and securities to be held in the same location.[150] To this end, some panelists advocated creation of a jointly organized effort, such as an advisory committee, that would be tasked with recommending a solution.[151]

D. Market Linkages and Clearing

The Treasury White Paper identifies direct competition between exchanges for trading like financial instruments as a goal that would make markets more efficient and "would benefit users of the markets, including investors and risk managers."[152] As the

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148 *See* Brodsky Testimony, *supra* note 52; Luthringshausen Testimony, *supra* note 59; Nazareth Testimony, *supra* note 141; Leitner Testimony, *supra* note 140; *see also* SIFMA Comment Letter, *supra* note 52; and Options Exchanges Comment Letter, *supra* note 52.

149 *See* Leibowitz Testimony, *supra* note 51.

150 *See* Brodsky Testimony, *supra* note 52; Luthringshausen Testimony, *supra* note 59; Nazareth Testimony, *supra* note 141; Leitner Testimony, *supra* note 140; *see also* Newedge Comment Letter, *supra* note 143; SIFMA Comment Letter, *supra* note 52; and Options Exchanges Comment Letter, *supra* note 52.

151 *See* Leibowitz Testimony, *supra* note 51, and Leitner Testimony, *supra* note 140; *see also* letter from Douglas Engmann, President, Engmann Options, Inc., to Mary Schapiro, Chairman, SEC, and Gary Gensler, Chairman, CFTC, dated September 13, 2009 ("Engmann Comment Letter").

152 Treasury White Paper, s*upra* note 1, at 49–50.

panelists noted at the September Meeting, at the exchange level, the securities and futures markets are structured differently: the former are linked in a national market system mandated by Congress, whereas the latter operate as largely separate, vertically integrated markets.

The Treasury White Paper's focus on direct competition between exchanges for trading like financial instruments also assumes that the financial instruments will be fungible, such that a position on one exchange and clearinghouse may be offset on another. Panelists and commentators at the September Meeting also addressed the issue of fungibility in the context of the current structural differences between the two markets and the rationales for the existence of such differences in the two regulatory regimes.

1. SEC Regulatory Framework

The Securities Exchange Act mandates a national market system for both trading and clearance and settlement of securities. The Securities Exchange Act's mandate makes a comprehensive regulatory approach essential because of the relationship between the markets for trading services and clearing services. In particular, the regulatory structure for clearing services can have an impact on the nature of competition in the market for trading services.

The SEC has administered the Securities Exchange Act by requiring that cleared securities products be fungible and that all brokers and exchanges have fair access to the clearing services offered by a central counterparty ("CCP"). In the Securities Act Amendments in 1975 (the "1975 Amendments"), Congress mandated that clearing systems be interconnected and operate under uniform rules, specifically finding 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."[153]

While originally each securities exchange's trading was cleared on its associated clearing agency, these clearing agencies were linked and coordinated in accordance with the national system for clearance and settlement mandated by the 1975 Amendments. Over time, these separate clearing agencies gave way to the emergence of a common clearing agency to clear and settle transactions in equity and fixed income securities. In the options markets, the SEC encouraged the development of a central clearing organization that issued and cleared standardized options traded on the competing exchanges.[154]

Product fungibility and fair access to clearing services are necessary for competition in the market for trading services. They enable market participants to establish a position at one trading venue and liquidate the position at another trading

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[153] Securities Exchange Act Section 17A(a)(1)(D), 15 U.S.C. 78q-1(a)(1)(D).

[154] In 1974, the SEC approved the OCC registration as a common clearing agency for exchange listed options. *See* Securities Exchange Act Release No. 11146 (December 19, 1974).

venue, yet still clear and settle the transactions through a centralized system just as efficiently as if they had traded at a single trading venue.

The national market system for trading is thus designed to promote fair and vigorous competition among multiple venues that simultaneously trade the same products, while also promoting the consolidation of trading interest necessary to address any adverse effects that might arise from the fragmentation of trading among multiple venues. There inherently is tension between these dual objectives of promoting competition among trading venues and minimizing the problems of fragmentation.

Competition among trading venues can generate benefits for market participants. It gives venues incentives to offer innovative trading tools and reliable systems at competitive fees. The existence of this competition, however, cannot be taken for granted because of the network effect that operates in trading markets – captured in the old saying that "liquidity attracts liquidity." As a single venue attracts more and more trading volume, each new participant in that venue enhances the value of the venue to both existing and prospective participants by adding liquidity and thereby enabling that venue to offer better prices. After an initial period of possibly vigorous competition among multiple venues, liquidity can be expected to tip to a single venue and stick there indefinitely.

Because of this network effect, any venue attempting to compete with the dominant venue will face a difficult challenge. Even if the new venue offers better technology and lower fees, it may not attract trading volume because it cannot assure its participants that they will receive prices that match the quality of executions available at the dominant venue. Moreover, the dominant venue may respond to competitive challenges by reducing fees in the short-term until a competitor is driven off, or by adopting improved technology that was developed and introduced by the competitor.

On the other hand, regulatory intervention designed to counter the network effect by promoting opportunities for competition among trading venues can, if successful, lead to fragmentation of trading interest among the competing venues. Market efficiency is enhanced when the most willing buyer in a product is able to trade with the most willing seller, but, in some circumstances, fragmentation can lead to impaired price discovery and higher transaction costs for market participants. In addition, multiple venues trading the same product can, in some circumstances, cause market participants to trade at inferior prices if their orders are not routed to the particular venue that has the best available prices at that time.

To secure the benefits of both competition among trading venues and consolidation of trading interest, the SEC has employed the following regulatory tools:

i. <u>Consolidated price transparency</u>. At the core of the national market system are the consolidated market data networks that collect the best-priced quotations (pre-trade transparency) and trade reports (post-trade transparency) from the various trading venues and disseminate the pricing

information to the public on a real-time basis. The consolidated data streams assure that all market participants have affordable access to a single source of pricing information for a product. Consolidated data is the principal tool both for addressing fragmentation (by enhancing the ability of participants to trade in the venue with the best prices) and promoting competition among trading venues (by preventing a dominant venue from restricting its prices to favored customers and by assuring that venues that display the best prices, even small ones, are able to disseminate those prices to all market participants).

ii. Fair access. It is not enough for market participants to know the best prices across different trading venues; they also must be able to access those prices efficiently at each venue. Trading venues in the national market system are required to provide access to market participants on terms that are not unfairly discriminatory. In particular, trading venues are not permitted to discriminate against market participants based on an association with, or trading at, competing venues.

iii. Trade-through protection and connectivity. Trading venues are prevented from executing trades at prices that are inferior to displayed quotations at other venues. This requirement provides greater assurance to market participants that they will receive the best available prices for their orders. It also provides strong incentives for trading venues to establish efficient connectivity with other trading venues. To attract order flow, trading venues offer routing services that seek out liquidity at other venues when the trading venue itself does not have liquidity at the best prices. These order routing services require extensive connectivity that closely link trading venues together.

iv. Duty of best execution. Brokers owe a duty of best execution to their customers to execute their orders at the most favorable terms reasonably available in the marketplace. This duty is particularly important when the broker has a choice of routing to many different venues that trade the same products. Brokers are required to undertake regular and rigorous reviews of the execution quality likely to be obtained from different trading venues. In this respect, the duty of best execution benefits both a broker's customers and the efficiency of the market system as a whole. The requirement that orders be routed to the best venues creates strong competitive pressures for venues to compete based on execution quality.

These regulatory tools have enabled the securities national market system to preserve an appropriate balance between two essential types of competition – competition among trading venues for order flow and competition among the orders of market participants in an individual product. In particular, the national market system has avoided the extremes of: (1) isolated venues that trade products without regard to trading on other venues and thereby fragment the competition among buyers and sellers in a

product; and (2) a single venue that overwhelmingly dominates trading in its products and thereby loses the benefits of vigorous competition and innovation among trading venues. Together, the two forms of competition generate vitally important benefits for market participants that otherwise would not be possible.

2. CFTC Regulatory Framework

Market Linkages

As discussed above, in legislation amending the securities laws, Congress mandated market linkage in the securities markets to increase competition among trading venues so that competing exchanges would offer lower trade execution fees. There has been no comparable legislative mandate for the futures markets. Accordingly, futures exchanges are not linked in a national market system in the manner Congress has prescribed for the securities markets. The current structure in the futures industry predates the passage of the CEA, and even of its predecessor, the Grain Futures Act of 1922. There has been no indication from Congress that there should be changes to that structure. Market differences that may account for the difference in approach include the fact that exchange listings in the securities markets are fungible securities issued by public companies, whereas futures exchange listings typically are highly specialized and differentiated contracts. This difference highlights one of the underlying purposes of the two markets: the securities markets principally address the need for capital formation and the futures markets are concerned with risk management.

Nevertheless, the CEA does not preclude futures exchanges from listing contracts with terms and conditions identical to those of contracts listed on other exchanges. However, the "first mover advantage," whereby trading generally gravitates to the market with pre-existing liquidity, typically leads to liquidity building and stabilizing in the exchange that first introduces a futures contract. Accordingly, once liquidity is established on one trading venue, others may be reluctant to invest resources in developing liquidity in the same product on their own platform.

Exchange-Directed Clearing

Under the CEA, individual exchanges and clearinghouses are governed by core principles, subject to oversight by the CFTC. The CEA also makes exchanges responsible for maintaining the fairness and financial integrity of trading in the contracts they list. These self-regulatory obligations are reflected in the statutory designation criteria and core principles that exchanges must satisfy. An exchange may delegate responsibility for compliance with core principles to another registered entity; however, under the CEA, the market remains ultimately responsible for satisfying the core principles.

To ensure financial integrity, a "board of trade shall establish and enforce rules providing for the financial integrity of any contracts traded on the contract market (including the clearance and settlement of the transactions with a derivatives clearing

organization)."[155] To fulfill this obligation, exchanges select the clearinghouse(s) that will clear and settle the contracts that they list, also known as "exchange-directed clearing." The clearinghouses associated with a futures exchange could either be vertically integrated into the market itself or serve as a third party clearing organizations. Historically, most clearinghouses have been integrated into their futures exchanges. The "exchange-directed clearing" characteristic of futures markets contrasts with "common clearing," which prevails in the securities markets, where Depository Trust and Clearing Corporation ("DTCC") clears all equity securities transactions and OCC clears security options transactions.

In addition to directing clearing, futures exchanges ordinarily do not treat contracts listed across markets as "fungible." "Fungibility" refers to a situation where identical contracts are listed on two different exchanges and a trader can establish a position on one exchange and close out that position on another exchange. Equity securities and equity options are considered to be fungible because they may be purchased on one exchange and sold on another. The reasons why futures exchanges have generally not accepted fungibility involve decreased incentives of a futures exchange to innovate product listings and potential exposure of one clearinghouse to the credit risks of another.

Futures contracts typically address specific risk management needs and thus often require considerable investment of resources for development, marketing, and on-going maintenance (*i.e.*, ensuring that the contracts stay up-to-date with changes in the underlying markets). The value of a futures contract is derived not only from its underlying commodity, but from the exchange-specific contract terms and conditions that are specifically designed by the futures exchange to address specific hedging needs. Contract maintenance involves significant costs, including ensuring deliverable supply both in terms of quantity and quality (i.e., adherence to specified contract terms). Accordingly, permitting listing of replica contracts on competing exchanges facilitates "free-riding" on the first exchange's investment and may decrease incentives favoring innovation.

Unless a transaction on one exchange can be cleared through the clearinghouse of another, fungibility would require each clearinghouse associated with competing exchanges to recognize a position offset or performance bond reduction based on a position cleared by another clearinghouse. This phenomenon is sometimes referred to as "inter-operability." Inter-operability would require a threshold risk management determination by one clearinghouse that it is prudent to take on the liability of the other. Clearinghouses may be reluctant to increase their interconnectedness to each other and thereby to assume each other's credit risks, which they may deem to be unreasonably high.

The futures clearing model contemplates competition among clearinghouses. A clearinghouse can compete on fees, operational efficiencies, financial strength, and

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[155] CEA Section 5(d)(11), 7 U.S.C. 7(d)(11).

effectiveness of risk management techniques (*i.e.*, a firm would be hesitant to join a clearinghouse if it had doubts about the clearinghouse's risk management program). In particular, competition with regard to operational efficiencies and risk management techniques could lead to innovation in the delivery of clearing services.

3. Analysis of SEC/CFTC Regulatory Frameworks

As a result of a mandate from Congress in 1975, the SEC has overseen the gradual creation of a national system of linked securities markets. The creation of this national market of linked execution platforms and exchanges has included issuance of regulations and guidelines concerning market transparency, best execution, trade-throughs, and intermarket competition. By contrast, Congress has not issued any such express mandate for the futures markets. As a result, the futures exchanges operate relatively independently of each other and, thus, the nature of intermarket competition between the securities and futures markets is different.

As noted by a number of panelists, the securities and futures markets differ significantly in their structure.[156] Identical securities are traded on multiple United States markets as part of the "national market system" for securities. Unlike securities, individual futures contracts generally are traded on the one exchange that creates the contract and such exchange typically has the first mover advantage in developing and retaining liquidity in the contract. Each exchange selects the clearinghouse for all instruments listed on that exchange. In the futures markets, competition exists among United States and foreign markets offering competing products, some of which may be similar in terms and functions, but are not fungible across markets and clearing organizations.

According to some panelists, the national market system for securities, including access to a common clearing utility, has encouraged vigorous competition between securities exchanges that has benefited market participants.[157] These panelists and commentators noted that, due to the existence of a common clearing facility, small entrants with innovative products and trading technologies can compete and garner substantial market share without substantial hurdles.[158] They also stated that the

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156 *See* Brodsky Testimony, *supra* note 52; Donohue Testimony, *supra* note 51, Harris Testimony, *supra* note 143; Nazareth Testimony *supra* note 141; and Short Testimony, *supra* note 93 ; *see also* letter from Neal Wolkoff, Chief Executive Officer, ELX Futures, September 14, 2009 ("ELX Futures Comment Letter").

157 *See, e.g.,* Harris Testimony, *supra* note 143; and Nazareth Testimony *supra* note 141. *See also* ELX Futures Comment Letter, *supra* note 156.

158 *See* Harris Testimony, *supra* note 143; and Nazareth Testimony *supra* note 141; *see also* Raisler Testimony, *supra* note 52 ("One example of this innovation is the promotion of fungibility in the equity options markets. Using a clearing house as a utility and allowing product to be cleared at the same clearing house regardless of where it is executed is an idea worth careful study in the futures and OTC markets. To the extent that the fungibility model has allowed new exchanges to enter the market and promote innovative products, and will encourage competition among exchanges and among clearing houses, it is worth considering.").

existence of a common clearer helps reduce systemic risk through enabling offsetting positions.[159] Thus, one suggestion for harmonizing securities and futures regulations and increasing competition among trading facilities in the futures markets was the adoption of fungibility for futures contracts similar to the structure for securities and equity options.[160]

Other panelists noted drawbacks to the common clearing model when it comes to futures markets.[161] According to this view, a trading facility that uses a utility-style clearinghouse is less likely to innovate for product development if competitors can immediately free ride off their ideas through a horizontal clearing model.[162] It was also stated that all futures markets across the globe currently operate under a vertical clearing model.[163] Moreover, some have observed that creation of a utility-style clearinghouse for futures markets would encourage payment for order flow.

Panelists observed that, notwithstanding common clearing, a disincentive to innovate has not been seen in the cash securities or security options markets.[164] In the cash securities markets, companies—rather than exchanges—issue securities that are fungible by design.[165] However, because exchanges--rather than the companies--design and list futures contracts, with endless possibilities for design of contract terms, futures exchanges claim there would be a disincentive to invest time and capital in designing better products for market participants unless they can have an opportunity to recoup this investment, which the vertical clearing model allows.[166] In this regard, however, securities options possess many characteristics similar to financial futures, including that they are derivative instruments that are designed and listed by exchanges, and options exchanges have been both competitive and innovative in developing new products.

A number of panelists added that creating one utility clearinghouse for futures would disrupt the market and would risk migration of business offshore in an age of electronic trading, which enables an exchange to be located nearly anywhere in the

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159 *See* Harris Testimony, *supra* note 143; and Nazareth Testimony *supra* note 141. *See also* ELX Futures Comment Letter, *supra* note 156.

160 *See* Leibowitz Testimony *supra* note 51; *see also* Transcript of Oral Testimony of David Downey, OneChicago, September 3, 2009, *supra* note 3 ("There needs to be a national clearing and settlement system for futures in America that is nondiscriminatory for qualified organizations to join, along the lines of the Options Clearing Corporation. This will allow for competition which would breed innovation as different organizations would compete to offer the fastest access through the best prices at the lowest cost").

161 *See* Leibowitz Testimony *supra* note 51; and Transcript of Oral Testimony of Craig Donohue, CME Group, September 3, 2009, *supra* note 3.

162 *See* Leibowitz Testimony *supra* note 51.

163 *See* Leibowitz Testimony, *supra* note 51; and Transcript of Oral Testimony of Craig Donohue, CME Group, Inc., September 2, 2009, *supra* note 3.

164 *See* Leibowitz Testimony *supra* note 51; and Harris Testimony, *supra* note 143.

165 *See* Nazareth Testimony *supra* note 141; and Leibowitz Testimony *supra* note 51.

166 *See* Leibowitz Testimony, *supra* note 51.

world.[167] One commentator noted that the solution to concentration in futures clearing is for the CFTC and SEC to approve more competitors to enter the space.[168]

Some panelists observed that steps short of fungibility could be taken by regulators to enhance competition among futures trading facilities.[169] Aside from vigorous antitrust enforcement, the panelists noted that the process and rights for market participants that want to move open interest to competing exchanges could be further clarified.[170] In the past, futures exchanges have claimed that open interest is owned and controlled by the exchange. According to these panelists, clearinghouses have a strong interest in managing their positions due to the systemic risk inherent in the business, and the risks associated with ownership and control of open interest has deterred market participants from taking positions to competing exchanges.[171] One proposal, therefore, would be to provide non-discriminatory open access, and to clarify the rights of market participants and clearinghouses regarding open interest as well as the process by which participants can transfer positions to other exchanges. Some panelists stated that this would significantly improve the ability of other exchanges to compete for business and that enhanced transparency of clearing fees would also allow users of the markets to be informed buyers of these services.[172]

Finally, one commentator stated that it would welcome a comprehensive study of how best to improve competition and the market structures for both futures and listed options markets.[173]

E. Prevention of Fraud and Manipulation

A number of panelists at the September Meeting identified manipulation as an area in which there was some divergence between the securities and futures laws. Some of the panelists suggested that some enhancements to the futures manipulation enforcement regime would be in order.

Panelists at the September Meeting noted that the securities and commodity futures laws cover insider trading very differently. Panelists and commentators explained that there are reasons for these differences, but some panelists indicated that the commodity futures laws could be modified somewhat to expand the scope of the insider trading preclusion.

1. SEC Regulatory Framework

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167 *Id.*

168 *Id.*

169 *Id.*

170 *Id.*

171 *Id.*

172 *Id.*

173 *See* FIA Comment Letter, *supra* note 59.

The SEC Division of Enforcement investigates possible violations of the federal securities laws, recommends SEC action when appropriate, either in a federal court or before an administrative law judge, prosecutes those actions, negotiates and recommends settlements, and administers the distribution of funds to harmed investors. The four primary statutes the Enforcement Division enforces are the Securities Act,[174] the Securities Exchange Act,[175] the Investment Company Act of 1940 (Investment Company Act),[176] and the Investment Advisers Act of 1940 (Advisers Act).[177]

Investigations and enforcement actions undertaken by the Enforcement Division include fraud by any person or entity, whether or not such actor is otherwise regulated by the SEC, where the violation is in connection with the offer, purchase, or sale of securities or security-based swap agreements. Areas of fraud enforcement include: financial fraud and disclosure violations by public issuers, fraud involving broker-dealers or associated persons, fraud involving mutual funds and investment advisers, fraud involving municipal securities, securities offering frauds (including Ponzi schemes), market abuse and manipulation, and insider trading. In addition to fraud, the Enforcement Division also investigates and prosecutes regulatory misconduct, including registration, reporting, and recordkeeping violations relating to issuers, broker-dealers, municipal securities dealers, investment advisers, investment companies, and transfer agents.

Rule 10b-5 under the Securities Exchange Act makes it unlawful for any person, directly or indirectly: (1) to employ any device, scheme, or artifice to defraud; (2) to make any untrue statements of material fact or to omit to state a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading; or (3) to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, "in connection with the purchase or sale" of any security.[178] Rule 10b-5 implements Section 10(b) of the Securities Exchange Act[179] prohibiting any person, in connection with a purchase or sale of any security or any security-based swap agreement, from using or employing any manipulative or deceptive device or contrivance in contravention of the SEC's rules and regulations. Similarly, Section 17 of the Securities Act makes it unlawful for any person, directly or indirectly: (1) to employ any device, scheme, or artifice to defraud; (2) to obtain money or property by means of any untrue statement of material fact or any omission to state a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading; or (3) to engage in any transaction, practice, or course of business which operates or would operate as a

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174 15 U.S.C. 77a *et seq*.

175 15 U.S.C. 78a *et seq*.

176 15 U.S.C. 80a-1 *et seq*.

177 15 U.S.C. 80b-1 *et seq*.

178 17 CFR 240.10b-5.

179 15 U.S.C. 78j(b).

fraud or deceit upon the purchaser, "in the offer or sale" of any security or any security-based swap agreement.[180]

Manipulation

Manipulation, in the context of the federal securities laws, is conduct designed to deceive or defraud investors by controlling or artificially affecting the price of securities. Manipulation cases brought by the SEC generally fall into two broad, sometimes overlapping categories: pump and dump cases and manipulative trading cases.

A pump-and-dump case generally involves the use of false disclosures to cause the price of a stock to go up – i.e., the price of a stock is "pumped" by the issuance of false or misleading press releases, spam emails, message board postings, or other promotional materials. In addition, a pump and dump scheme may include some of the classic manipulative trading techniques described below.

In manipulative trading cases, a stock's price is artificially affected not by false disclosures, but by artificial or deceptive trading conduct. Examples of manipulative trading practices include effecting wash sales (transactions in which there is no change in beneficial ownership) or matched trades (pre-arranged transactions to artificially maintain or otherwise affect a stock's price), painting the tape (buying activity among nominee accounts at increasingly higher prices or causing fictitious transactions reports to appear on the ticker tape), and marking the close (placing orders at or near the close of the market in order to inflate the reported closing price).

Both pump-and-dump and manipulation trading cases can be brought under the general antifraud provisions described above. In a case brought under Section 10(b) and Rule 10b-5, the SEC is required to establish that the violator acted with scienter, a mental state that the courts have held is satisfied by knowing or reckless conduct.

In addition, Section 9 of the Securities Exchange Act specifically outlaws certain manipulative practices in connection with the trading of exchange-listed securities.[181] Section 9(a)(1) makes it unlawful for any person, directly or indirectly, for the purpose of creating a false or misleading appearance of active trading in any security registered on a national securities exchange, or a false or misleading appearance with respect to the market for any such security: (1) to effect any transaction in such security which involves no change in the beneficial ownership thereof (i.e., a wash sale); or (2) to enter an order for the purchase or sale of such security with the knowledge that an order of substantially the same size, at substantially the same price, for the sale or purchase of any such security, has been or will be entered by or for the same or different parties (i.e., a matched trade).[182] Section 9(a)(2) makes it unlawful for any person, directly or indirectly, to effect a series of transactions in any security registered on a national

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[180] 15 U.S.C. 78q.

[181] 15 U.S.C. 78i.

[182] 15 U.S.C. 78i(a)(1).

securities exchange or in connection with any security-based swap agreement with respect to such security creating actual or apparent active trading in such security, or raising or depressing the price of such security, for the purpose of inducing the purchase or sale of such security by others.[183] Both Sections 9(a)(1) and (2) require that the proscribed activities be engaged in with the requisite manipulative intent. However, a finding of manipulative intent may be inferred from circumstantial evidence.

Several other provisions of, and rules under, the Securities Exchange Act govern particular types of manipulative activities. For example, Section 9(a)(6) gives the SEC the authority to promulgate rules prohibiting "pegging, fixing or stabilizing" securities prices.[184] Section 15(c) of the Securities Exchange Act[185] covers the OTC markets and municipal securities. With respect to abusive naked short selling, Rule 10b-21 of the Securities Exchange Act makes it unlawful for any person to submit an order to sell an equity security if such person deceives a broker-dealer, participant of a registered clearing agency, or purchaser regarding its intention or ability to deliver the security and such person fails to deliver the security.[186] Regulation M precludes certain activities that could artificially influence the market in an initial or secondary offering of securities.[187] There is no scienter requirement for violations of Regulation M.

Insider Trading

Insider trading is prosecuted as a type of fraud under the federal securities laws. In general, insider trading refers to buying or selling securities on the basis of material, nonpublic information in breach of a duty. The prohibitions against insider trading have been developed largely by SEC and court decisions arising under the general antifraud provision of Section 10(b) of the Securities Exchange Act[188] and Rule 10b-5 thereunder.[189]

The courts have recognized two different "theories" of insider trading. Under what is known as the "traditional" or "classical theory" of insider trading, it is a violation of Section 10(b) and Rule 10b-5 for corporate insiders – a category that includes officers, directors, and employees of a corporation, as well as certain outside advisers or consultants who temporarily become fiduciaries of the corporation – to trade in the securities of their corporation on the basis of material, nonpublic information.[190] Under the classical theory, trading on such information is fraudulent because the insider, who

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183 15 U.S.C. 78i(a)(2).

184 15 U.S.C. 78i(a)(6).

185 15 U.S.C. 78o(c).

186 17 CFR 240.10b-21.

187 17 CFR 242.100 *et seq*.

188 17 U.S.C. 78j(b).

189 17 CFR 240.10b-5.

190 *United States v. O'Hagan*, 521 U.S. 642 (1997).

has a relationship of trust and confidence with the corporation's shareholders, is under a duty to disclose the material information that is not known to the shareholders if the insider decides to trade.[191] This is to prevent the insider from taking unfair advantage of uninformed shareholders.[192]

The second theory of insider trading is the "misappropriation theory." Under the misappropriation theory, a person violates Section 10(b) and Rule 10b-5 "when he misappropriates confidential information for securities trading purposes, in breach of a duty owed to the source of the information."[193] The Supreme Court has affirmed this theory, holding that the misappropriator's use of the principal's information "to purchase or sell securities, in breach of a duty of loyalty and confidentiality, defrauds the principal of the exclusive use of that information."[194] As the Court explained, the theory serves "an animating purpose of the Securities Exchange Act: to insure honest securities markets and thereby promote investor confidence. . . . [I]nvestors likely would hesitate to venture their capital in a market where trading based on misappropriated nonpublic information is unchecked by law."[195]

In addition, Section 16(b) of the Securities Exchange Act imposes liability for short-swing profits in the issuer's stock upon all persons required to file reports under Section 16(a) of the Securities Exchange Act (officers, directors and beneficial owners of more than ten percent of any class of equity security). These statutory insiders must disgorge to the issuer any profit realized as a result of a purchase and sale or sale and purchase of covered equity securities occurring within a six-month period.

In order to prevent insiders and misappropriators of information from indirectly exploiting material nonpublic information, the courts have also held that Section 10(b) and Rule 10b-5 prohibit "tipping" – that is, the improper disclosure of material nonpublic information to another person who engages in trading. Further, in a tipping case, trading by the recipients of the information – the "tippees" – will also violate Section 10(b) and Rule 10b-5 when the insider's disclosure has been in breach of a duty and the tippee knows or should know that there has been a breach.[196]

The SEC has also adopted a specific rule addressing insider trading in connection with tender offers – Rule 14e-3.[197] This rule prohibits trading while in possession of material, nonpublic information relating to a tender offer if any person has taken a substantial step or steps toward a tender offer, and the person knows or has reason to

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191 *Chiarella v. United States*, 445 U.S. 222, 228 (1980).

192 *O'Hagan*, 521 U.S. at 652, citing *Chiarella v. United States.* See also *Cady, Roberts & Co.*, 40 S.E.C. 907 (1961).

193 *Id*.

194 *Id.*

195 *O'Hagan*, 521 U.S. at 658.

196 *Dirks v. SEC*, 463 U.S. 646, 660 (1983).

197 17 CFR 240.14e-3.

know that the information is nonpublic and came directly or indirectly from a proscribed source, such as the offeror, the target, or persons acting on their behalf. Rule 14e-3 does not require any showing of a breach of duty.

Remedies

The SEC can seek "disgorgement" of ill-gotten gain pursuant to the court's equitable powers in federal court cases and is authorized to seek disgorgement by statute in administrative and cease-and-desist proceedings.[198] Disgorgement is a remedy that is designed to deprive a wrongdoer of ill-gotten gains.[199] It extends to the amount, with interest, by which a defendant profited from his wrongdoing,[200] which in some cases differs from the amount of victim losses. In the Sarbanes-Oxley Act of 2002, Congress also provided that courts, in actions brought by the SEC, may order "any equitable relief that may be appropriate or necessary for the benefit of investors."[201]

The SEC can also obtain civil monetary penalties for violations. Section 308(a) of the Sarbanes-Oxley Act of 2002 authorizes the SEC to add civil penalty amounts to any disgorgement fund for distribution to harmed investors.[202]

2. CFTC Regulatory Framework

Manipulation

A core purpose of the Commodity Securities Exchange Act is "to deter and prevent price manipulation or any other disruptions to market integrity."[203] The CEA prohibits manipulation and attempts to manipulate price in both the commodity futures markets and commodity cash markets, together with cornering or attempting to corner any such commodity.[204]

Three statutory provisions (other than Section 22, which deals with private actions) authorize suit in both futures and cash market manipulation cases: Sections 6(c), 6(d) and 9(a)(2).[205] A person violates Sections 6(c) and 6(d) if he or she "is manipulating or attempting to manipulate or has manipulated or attempted to manipulate the market price of any commodity, in interstate commerce**,** or for future delivery on or

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198 *See, e.g.*, Section 8A of the Securities Act, 15 U.S.C. 77h-1, and Sections 21B and 21C of the Securities Exchange Act, 15 U.S.C. 78u-2 and 15 U.S.C. 78u-3, respectively.

199 *SEC v. Blavin*, 760 F.2d 706 (6th Cir. 1985).

200 *SEC v. Blatt*, 583 F.2d 1325, 1335 (5th Cir. 1985).

201 Section 21(d)(5) of the Securities Exchange Act, 15 U.S.C. 78u(d)(5).

202 15 U.S.C. 7246(a).

203 CEA Section 3(b), 7 U.S.C. § 5(b).

204 CEA Section 9(a)(2), 7 U.S.C. § 13(a)(2).

205 7 U.S.C. 9, 13b, and 13(a)(2).

subject to the rules of any registered entity." Similarly, Section 9(a)(2) provides that it is unlawful for "[a]ny person to manipulate or attempt to manipulate the price of any commodity in interstate commerce**,** or for future delivery on or subject to the rules of any registered entity, or to corner or attempt to corner any such commodity."

The element of intent often distinguishes manipulative from non-manipulative trading.[206] A core concept underlying this element is "an intentional exaction of a price determined by forces other than supply and demand,"[207] or conduct "with the purpose or conscious object of causing or effecting a price or price trend in the market that did not reflect the legitimate forces of supply and demand."[208] While "knowledge of relevant market conditions is probative of intent, it is not necessary to prove that the accused knew to any particular degree of certainty that his actions would create an artificial price." It is thus sufficient "to present evidence from which it may reasonably be inferred that the accused 'consciously desire[d] that result, whatever the likelihood of that result happening from his conduct.'"[209]

Separate from the general anti-manipulation provisions under the CEA, specific manipulative practices are prohibited in both the statute and in the CFTC's regulations. For example, the CEA prohibits knowingly false or misleading reports "concerning crop or market information or conditions that affect or tend to affect the price of any commodity in interstate commerce."[210] The CEA also makes it a violation to "knowingly" exceed the limits set by either a contract market or the Commission "on the amount of trading which may be done or positions which may be held by any person under contracts of sale of any commodity for future delivery."[211] The purpose of position limit rules is to prevent market manipulation, price instability, and market disorder as futures contracts reach their expiration date.[212] The CEA prohibits a person from offering to enter into, entering into or confirming the execution of any transaction that is, is of the character of, or is commonly known to the trade as, a "wash sale" or "accommodation trade"; is a fictitious sale; or is used to cause any price to be reported, registered, or recorded that is not a true and bona fide price.[213] Finally, the statute prohibits willful false, fictitious, or fraudulent statements or representations, or making or using any false

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206 *In re Indiana Farm Bureau*, ¶ 21,796 at 27,282 (stating that "intent is the essence of manipulation…"); *In re Hohenberg Bros. Co.*, ¶ 20,271 at 21,447.

207 *Frey*, 931 F.2d at 1175.

208 *Indiana Farm Bureau*, ¶ 21,796 at 27,283; *see also Volkart Bros. v. Inc. v. Freeman*, 311 F.2d at 58 ("a purpose to create prices not responsive to the forces of supply and demand; the conduct must be 'calculated to produce a price distortion'").

209 *Indiana Farm Bureau*, ¶ 21,796 at 27,283, *quoting U.S. v. United States Gypsum Co.*, 438 U.S. at 445.

210 CEA Section 9(a)(2), 7 U.S.C. 13(a)(2).

211 CEA Section 4a(e), 7 U.S.C. 6a(e).

212 *See Saberi v. CFTC*, 488 F.3d 1207 (9th Cir. 2007).

213 CEA Section 4c(a), 7 U.S.C. 6c(a).

writing or document knowing that it contains any false, fictitious, or fraudulent statement or entry to a registered entity, board of trade, or futures association.[214]

Insider Trading

Trading on material non-public information is prohibited under the CEA, but only with respect to three general categories of persons. First, the statute prohibits CFTC Commissioners, employees and agents from trading on non-public information.[215] The statute similarly prohibits Commissioners and CFTC employees from delivering non-public information to third parties with the intent to assist them in conducting trades; the CEA also forbids individuals who receive this information from trading on it.[216] Finally, the CEA prohibits employees and board/committee members of a board of trade, registered entity, or registered futures association, from willfully and knowingly trading for their own or on behalf of any other account, futures or options contracts on the basis of any material non-public information obtained through special access related to the performance of their duties.[217] These felony violations are punishable by fines of up to $500,000, plus the amount of any profits realized from the trading. In the case of criminal prosecutions, there is a maximum sentence of five (5) years.

3. Analysis of SEC/CFTC Regulatory Frameworks

Manipulation

Manipulation is unlawful under both the securities and futures laws. While there is some overlap in the concepts of manipulation as they relate to the securities and futures markets, panelists observed that the fact patterns of manipulation cases often differ between the two markets. In securities markets, for example, attempts to "corner" a market in a particular stock (or to "squeeze" the shorts) are relatively rare; the more common manipulation case in the securities field is the "pump and dump" scheme, which involves dissemination of false information to raise the price of a stock.

In futures markets, corners, squeezes, and the use of manipulative trading practices are of primary concern. As a result, some panelists noted that the standards that would satisfy a finding of scienter in the making of a false statement under the securities laws (e.g., "recklessness" under Rule 10b-5) may not fit precisely with all varieties of manipulation in the futures markets.[218]

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214 CEA Section 9(a)(4), 7 U.S.C. 13(a)(4).

215 CEA Section 9(c), 7 U.S.C. 13(c).

216 CEA Section 9(d), 7 U.S.C. 13(d).

217 CEA Section 9(e), 7 U.S.C. 13(e).

218 *See* Testimony of John Coffee, Professor, Columbia University School of Law, September 3, 2009 ("Coffee Testimony"); and Short Testimony, *supra* note 93.

Some commentators stated that the CEA's manipulation standard itself has been working well, and cited to the CFTC's enforcement successes.[219] Others, however, noted that the existence of financial derivatives under the jurisdiction of the CFTC, which would expand significantly if and when the OTC market comes under the agency's jurisdiction, made it critical to seek appropriate statutory changes to enhance the CFTC's authority.[220] It was noted that a vigorous and coordinated approach to enforcement by both agencies can help prevent jurisdictional overlap from creating enforcement gaps and the potential for regulatory arbitrage.[221]

Some panelists proposed that the agencies form a staff-level joint task force to ensure comprehensive and consistent fraud and manipulation detection across the two marketplaces.[222] More specific to the futures markets, one speaker advocated adoption of suggestions made by Professor Jerry Markham in a 1991 article.[223] The suggestions in that article included a combination of statutory changes and active market surveillance, which would include the ability to take action to prevent market congestion.[224]

Insider Trading

As a number of panelists observed, the approaches of the securities laws and the futures laws diverge on the issue of insider trading.[225] 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 (except for the categories of persons enumerated above). The difference between the statutes is attributable in part to the historical functions of the futures markets to permit hedgers to protect themselves against risks to their commodity positions based on their own knowledge of those positions.

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219 *See, e.g.*, FIA Comment Letter, *supra* note 59.

220 *See, e.g.*, Silvers Testimony, *supra* note 59.

221 *See* Raisler Testimony, *supra* note 52; Silvers Testimony, *supra* note 59; and Testimony of Daniel Roth, President and Chief Executive Officer, National Futures Association, September 3, 2009 ("Roth Testimony").

222 *See* Silvers Testimony, *supra* note 59; and Testimony of Richard Owens, Partner, Latham & Watkins, September 3, 2009 ("Owens Testimony"); *see also* Transcript of Oral Testimony of William McLucas, Partner, Wilmer Cutler Pickering Hale and Dorr, September 3, 2009 ("McLucas") and John Coffee, Professor, Columbia University School of Law, September 3, 2009, *supra* note 3.

223 *See* Coffee Testimony, *supra* note 218.

224 Unlike the SEC, the CFTC possesses the authority to set position limits with respect to commodity futures contracts. The suggestion made in Professor Markham's article was proactive use of the CFTC's authority to set position limits as a means of complementing enforcement against manipulation. *See* Jerry W. Markham, *Manipulation of Commodity Futures Prices – The Unprosecutable Crime*, 8 Yale J. on Reg. 281 (1991).

225 *See* Brodsky Testimony, *supra* note 52; Nazareth Testimony, *supra* note 141; Raisler Testimony, *supra* note 52; Short Testimony, *supra* note 93; Silvers Testimony, *supra* note 59; Coffee Testimony, *supra* note 218; and Young Testimony, *supra* at 143; *see also* Newedge Comment Letter, *supra* note 143; FIA Comment Letter, *supra* note 59; and Options Exchanges Comment Letter, *supra* note 52.

Thus, unlike securities cases brought under the classical theory of insider trading, where trading while in possession of material nonpublic company information by management insiders is in breach of a fiduciary obligation to shareholders, use of inside information by a company to hedge its risks is integral to futures markets and does not give rise to similar concerns.

Accordingly, a number of panelists and commentators noted that insider trading laws should not be extended to customers engaging in bona fide futures hedging activities.[226] However, panelists and commentators did state that some extension of insider trading laws would be appropriate.[227] Specifically, the CEA prohibits CFTC and futures SRO officials and staff from using for their own trading purposes any nonpublic information they receive through their official duties. The CEA also prohibits CFTC and SRO personnel from tipping off anyone about trading opportunities based on nonpublic information received in their official capacities. According to these panelists, these prohibitions should be extended to all other SROs (like securities exchanges), other U.S. government agencies and departments, and members of Congress and their staffs.[228]

Panelists had mixed views on the potential application of the misappropriation theory of insider trading to the futures markets.[229] One commentator noted that theft or a breach of ethical duties for personal enrichment by professionals of any kind is always wrong, but added that the CFTC and the SROs have ample authority under current law to prosecute employees of regulated intermediaries who breach an intermediary's duties to its customers by purloining a customer's trading plans or strategy and trading ahead for personal gain.[230] Other commentators stated that the misappropriation theory could apply to professionals and certain other categories of individuals who have access to material, nonpublic information relating to the futures markets and misuse that information for their own trading purposes.[231]

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226 *See* Short Testimony, *supra* note 93; and Young Testimony, *supra* note 143. *See also* FIA Comment Letter, *supra* note 59; and Newedge Comment Letter, *supra* note 143.

227 *See* Brodsky Testimony, *supra* note 52; Nazareth Testimony, *supra* note 141; Silvers Testimony, *supra* note 59; and Coffee Testimony, *supra* note 218. *See also* Newedge Comment Letter, *supra* note 143; FIA Comment Letter, *supra* note 59; and Options Exchanges Comment Letter, *supra* note 52.

228 *See* FIA Comment Letter, *supra* note 59 and Newedge Comment Letter, *supra* note 143 ("We believe that insider trading laws should not be applied to customers engaging in bona fide futures hedging activities. However, we do believe that the various evolving theories of misappropriation should be applied to professionals and certain other categories of individuals who have access to material, nonpublic information relating to the futures markets but who are not themselves conducting hedging activities.").

229 *See* Brodsky Testimony, *supra* note 52; Coffee Testimony, *supra* note 218; Nazareth Testimony, *supra* note 141; Short Testimony, *supra* note 93; Silvers Testimony *supra* note 59; Young Testimony, *supra* note 143; *see also* FIA Comment Letter, *supra* note 59; Newedge Comment Letter, *supra* note 143; and Options Exchanges Comment Letter, *supra* note 52.

230 *See* FIA Comment Letter, *supra* note 59.

231 *See* Coffee Testimony, *supra* note 218; *see also* Newedge Comment Letter, *supra* note 143; FIA Comment Letter, *supra* note 59.

In terms of potential enforcement remedies, some observed that, unlike the CFTC, the SEC lacks statutory authority to seek restitution.[232] The SEC can seek disgorgement of ill-gotten gains in court and in administrative and cease-and-desist proceedings and distribute those funds to victims of fraud. When penalties are also sought along with disgorgement, those penalties may also be distributed to victims. Disgorgement, however, is measured by reference to the wrongdoer's ill-gotten gain, not the victim's losses.

Another difference between the two regulatory frameworks includes that the CFTC's specific statutory authority for aiding and abetting violations. The SEC has specific statutory authority for aiding and abetting under the Securities Exchange Act and the Advisers Act but not under the Securities Act or the Investment Company Act.

F. Obligations to Investors and Customers

The securities and futures regulatory regimes each impose customer protection obligations and standards to govern the conduct of financial intermediaries that provide advisory services to customers. These standards, however, are varied, and differ between financial advisers that operate under the two regulatory regimes. Thus, while the same customer may be purchasing both securities and futures products from these intermediaries for the same overall trading and investment purposes, the advisers are nevertheless subject to different customer protection requirements depending on the nature of the product at issue.

1. SEC Regulatory Framework

Customer Protection

Broker-dealers are subject to a comprehensive set of Commission and SRO requirements that are designed to promote business conduct that would facilitate fair, orderly and efficient markets and protect investors from abusive practices.

Broker-dealers are required to deal fairly with their customers. This duty is derived from the anti-fraud provisions of the federal securities laws.[233] Under the so-called "shingle" theory, by virtue of engaging in the brokerage profession, a broker-dealer makes an implicit representation to those persons with whom it transacts business that it will deal fairly with them, consistent with the standards of the profession.[234] This

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232 *See* Owens Testimony, *supra* note 222.

233 *See* SEC, Report of the Special Study of Securities Markets of the Securities and Exchange Commission, H.R. Doc. No. 88-95, at 238 (1st Sess. 1963) ("Report of Special Study"); *Richard N. Cea*, 44 S.E.C. 8, 18 (1969) (involving excessive trading and recommendations of speculative securities without a reasonable basis); *Mac Robbins & Co.*, 41 S.E.C. 116 (1962) (involving "boiler-room" sales tactics of speculative securities).

234 *See, e.g., Charles Hughes & Co. v. SEC*, 139 F.2d 434 (2d Cir. 1943), *cert. denied*, 321 U.S. 786 (1944) (although not expressly referencing the "shingle theory," held that broker-dealer was under

essential representation proscribes certain conduct, which has been articulated by the Commission and courts over time through interpretive statements and enforcement actions.[235]

Broker-dealers also are required under SRO rules to observe high standards of commercial honor and just and equitable principles of trade.[236] This includes having a reasonable basis for recommendations in light of customer financial situation to the extent known to the broker (suitability), engaging in fair and balanced communications with the public, providing timely and adequate confirmation of transactions, providing account statement disclosures, disclosing conflicts of interest, receiving fair compensation both in agency and principal transactions, and giving customers the opportunity for redress of disputes through arbitration.[237] The Commission's and the SROs' books and records rules help to ensure that regulators can access information regarding broker-dealer trading activity, to examine for compliance with sales practice obligations.

Moreover, a broker-dealer has a legal duty to seek to obtain best execution of customer orders.[238] This duty derives from common law, and is incorporated in SRO rules and, through judicial and Commission decisions, the anti-fraud provisions of the federal securities laws.[239] The duty of best execution requires broker-dealers to execute

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a "special duty, in view of its expert knowledge and proffered advice, not to take advantage of its customers' ignorance of market conditions"; failure to disclose substantial mark-ups on OTC securities sold to unsophisticated customers thus constituted fraud).

235 *See supra* note 233.

236 *See* FINRA Rule 2010 ("Standards of Commercial Honor and Principles of Trade"). FINRA rules also generally require broker-dealer compensation for services to be fair and reasonable taking into consideration all relevant circumstances. *See* NASD (FINRA) Rule 2440. FINRA members are also prohibited from charging unfair or unreasonable underwriting compensation in connection with the distribution of securities. *See* FINRA Rule 5110(c).

237 *See, e.g.*, NASD (FINRA) Rule 2310 ("Recommendations to Customers (Suitability)"); NASD (FINRA) Rule 2010(d) ("Communications with the Public"); Securities Exchange Act Rule 10b-10 (confirmation of transactions); MSRB Rule G-15 (confirmation of transactions); NASD Rule 2230 ("Confirmations"); Securities Exchange Act Rule 15c3-2 (account statements); NASD (FINRA) Rules 2340 ("Customer Account Statements"); NASD (FINRA) Rule 2720 ("Public Offerings of Securities With Conflicts of Interest"); NASD (FINRA) Rule 3040 ("Private Securities Transactions of an Associated Person"); NASD (FINRA) Rule 2440 ("Fair Prices and Commissions"); FINRA Rule 5110(c); FINRA IM 12000. *See also*, *infra* note 241 for a discussion of the information a broker-dealer must obtain prior to executing a transaction recommended to a non-institutional customer.

238 *See, e.g., Newton v. Merrill, Lynch, Pierce, Fenner & Smith, Inc.*, 135 F.3d 266, 269-270 (3d Cir.), cert. denied, 525 U.S. 811 (1998); *Certain Market Making Activities on Nasdaq*, Securities Exchange Act Release No. 40900 (Jan. 11, 1999) (settled case) (citing *Sinclair v. SEC*, 444 F.2d 399 (2d. Cir. 1971); *In re Arleen Hughes*, 27 S.E.C 629, 636 (1948), aff'd sub nom., *Hughes v. SEC*, 174 F.2d 969 (D.C. Cir. 1949). *See also Order Execution Obligations*, Securities Exchange Act Release No. 37619A (Sept. 6, 1996), 61 FR 48290 (Sept. 12, 1996) ("Order Handling Rules Release"). *See also Regulation NMS*, Securities Exchange Act Release No. 51808 (June 9, 2005), 70 FR 37496 (June 29, 2005) ("Regulation NMS Release").

239 *See* Regulation NMS Release, *supra* note 238.

customers' trades at the most favorable terms reasonably available under the circumstances.[240]

As noted above, a central aspect of a broker-dealer's duty of fair dealing is the suitability obligation. The concept of suitability appears in specific SRO rules[241] and has also been interpreted as an obligation under the anti-fraud provisions of the federal securities laws.[242] In contrast to the concept of suitability under the federal securities laws, which is based in fraud, the SRO rules are grounded in concepts of professionalism, fair dealing, and just and equitable principles of trade.

The anti-fraud provisions of the federal securities laws and the implied obligation of fair dealing thereunder prohibit broker-dealers from, among other things, making unsuitable recommendations and require broker-dealers to investigate an issuer before recommending the issuer's securities to a customer.[243] The fair dealing obligation also requires the broker-dealer to reasonably believe that its securities recommendations are suitable for its customer in light of the customer's financial needs, objectives and circumstances (customer-specific suitability).[244]

Like all other actions for violating anti-fraud provisions, the SEC must establish that the broker's unsuitable recommendation was made with scienter (*i.e.* with a mental state embracing intent to deceive, manipulate or defraud). Scienter can be knowing misconduct as well as reckless misconduct: conduct that is "at the least, conduct which is 'highly unreasonable' and which represents 'an extreme departure from the standards of ordinary care…to the extent that the danger was either known to the defendant or so

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240 *Id.*

241 NASD members' suitability obligations are set out in NASD Rule 2310, "Recommendations to Customers (Suitability)," and NASD Interpretive Materials ("IMs"), specifically, IM 2310-1 ("Possible Application of SEC Rules 15g-1 through 15g-9"), 2310-2 ("Fair Dealing with Customers"), and 2310-3 ("Suitability Obligations to Institutional Customers"), as applicable. Suitability obligations of brokers, dealers, and municipal securities dealers in connection with transactions in municipal securities are set out in MSRB Rule G-19. Aside from the area of options (where there is a specific suitability requirement under NYSE Rule 723), the exchanges address suitability violations under rules imposing a duty of due diligence (*e.g.*, Incorporated NYSE Rule 405 ("Diligence as to Accounts", also known as the "Know Your Customer Rule")).

Specifically, NASD Rule 2310 requires that members "have reasonable grounds for believing that the recommendation is suitable for such customer upon the basis of the facts, if any, disclosed by such customer as to his other security holdings and as to his financial situation and needs." In addition, before executing a recommended transaction for a non-institutional customer, members must "make reasonable efforts to obtain information concerning: (1) the customer's financial status; (2) the customer's tax status; (3) the customer's investment objectives; and (4) such other information used or considered to be reasonable by such member or registered representative in making recommendations to the customer."

242 *See infra* note 243.

243 *See Hanley v. SEC*, 415 F.2d 589, 596 (2d Cir. 1969); *see also* Securities Exchange Act Release No. 26100, at n. 75 (Sept. 22, 1988), 53 Fed. Reg. 37778 (Sept. 28, 1988).

244 *See Richard N. Cea*, Securities Exchange Act Release No. 8662 (Aug. 6, 1969); *F.J. Kaufman and Co.*, Securities Exchange Act Release No. 27535 (Dec. 13, 1989).

obvious that the defendant must have been aware of it.'"[245] In contrast to the federal anti-fraud provisions, FINRA and other SRO rules do not require proof of scienter to establish a suitability violation primarily enforced by the SROs.[246] As noted above, while the concept of suitability under the federal securities laws is grounded in fraud, the SRO rules are grounded in concepts of professionalism, fair dealing, and just and equitable principles of trade, which gives SROs greater latitude in dealing with suitability issues.[247] A violation of the suitability requirements as interpreted under the anti-fraud provisions can also give rise to a private cause of action and civil liability under Section 10(b) of the Securities Exchange Act and Rule 10b-5 thereunder.[248] Although the SROs' suitability rules do not similarly give rise to a private cause of action, violations of the rules can be addressed through arbitration proceedings.

In general, there are two approaches to suitability that have developed under both U.S. case law and FINRA and SEC enforcement actions – "reasonable basis" suitability and "customer-specific" suitability. Under reasonable basis suitability, a broker-dealer has an affirmative duty to have an "adequate and reasonable basis" for any recommendation that it makes.[249] A broker-dealer, therefore, has the obligation to

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245 *See Ernst & Ernst v. Hochfelder*, 425 US 185 (1976), and *Rolf v. Blyth, Eastman Dillon & Co., Inc.*, 570 F.2d 38, 47 (2d Cir. 1978) (holding that scienter can be reckless conduct).

246 *See, e.g., In re Jack H. Stein*, Securities Exchange Act Release No. 47335 (Feb. 10, 2003) ("Scienter is not an element for finding a violation of the NASD suitability rule."); *In re John M. Reynolds*, Securities Exchange Act Release No. 30036 (Dec. 4, 1991) (scienter unnecessary to establish excessive trading under NASD rules).

247 When adopted, the SRO rules, particularly the NASD rule, were regarded primarily as ethical rules, stemming from concepts of "fair dealing" and notions of ''just and equitable principles of trade." Robert Mundheim, *Professional Responsibilities of Broker-Dealers: The Suitability Doctrine*, 1965 Duke L.J. 445-47; Stuart D. Root, *Suitability—The Sophisticated Investor—and Modern Portfolio Management*, 1991 Colum. Bus. L. Rev. 287, 290-300.

248 *See, e.g., Brown v. E.F. Hutton Group, Inc.*, 991 F.2d 1020, 1031 (2d Cir. 1993); *O'Connor v. R.F. Lafferty & Co.*, 965 F.2d 893 (10th Cir. 1992); *Vucinich v. Paine Webber, Jackson & Curtis, Inc.*, 803 F.2d 454 (9th Cir. 1986).

249 *See F.J. Kaufman and Co.*, 50 S.E.C. 164, 1989 WL 259961 (1989), in which a broker-dealer recommended a strategy that combined writing covered call options on a security along with margin purchases. The strategy was found to be unsuitable because it was an objectively inferior strategy: it was always more profitable for the customer simply to make margin purchases of the underlying stock. The broker's recommendations violated suitability requirements because the broker did not have a reasonable basis for the strategy he recommended, wholly apart from any considerations relating to the particular customer's portfolio. *See also Hanly v. SEC*, 415 F.2d 589, 597 (2d Cir. 1969) (upholding Commission bar of individuals for failing to disclose "known or reasonably ascertainable adverse information" relating to the issuer, and holding that brokers are under a duty to investigate issuers and "cannot recommend a security unless there is an adequate and reasonable basis for such recommendation"); *In re Walston & Co.*, Rel. No. 34-8165, 43 S.E.C. 508, 1967 WL 87755 (1967) (broker lacked adequate basis for recommending municipal bonds whose issuer had no reasonable ability to service the bonds); *Michael F. Siegel*, 2007 NASD Discip. LEXIS 20 (NAC May 11, 2007) (finding that registered representative lacked any reasonable basis for recommending securities because he did not have sufficient understanding of what he was recommending and his testimony demonstrated that the securities recommended were not suitable for any investor).

investigate and have adequate information about the security it is recommending. Under customer-specific suitability, a broker-dealer must make recommendations based on a customer's financial situation and needs as well as other security holdings, to the extent known.[250] This requirement has been construed to impose a duty of inquiry on broker-dealers to obtain relevant information from customers relating to their financial situations[251] and to keep such information current.[252]

In addition, more specific suitability, disclosure, and due diligence requirements apply to certain other securities products as well, including among other things penny stocks, options, mutual fund share classes, debt securities and bond funds, municipal securities, hedge funds, variable insurance products, and non-traditional products, such as structured products and leveraged and inverse exchange-traded funds. For example, certain broker-dealers selling penny stocks must comply with stringent suitability and disclosure obligations.[253]

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250 *See Richard N. Cea*, Securities Exchange Act Release No. 8662 (Aug. 6, 1969); *F.J. Kaufman and Co.*, Securities Exchange Act Release No. 27535 (Dec. 13, 1989). *See also*, In re Luis Miguel Cespedes, Securities Exchange Act Release No. 59404 (February 13, 2009) finding that a registered representative recommendations that customers invest with significant concentrations in the technology sector, often using margin to purchase the securities, were unsuitable in light of the customers' ages, financial situations and needs, investment experience, and personal circumstances of the customers); In re Maughan, NYSE Disc. Dec., 2004 WL 1801597 (June 30, 2004) (purchases of aggressive and speculative technology, biotech, and internet stocks on margin, in addition to the frequency of trading and concentration in these stocks, unsuitable in view of 65-year-old retiree's age, investment objectives, and financial circumstances); Dep't of Enforcement v. Stein, NASD Disc. Dec., 2001 WL 156957 (2001) (strategy of investing nearly 90% of customer's funds in oil, gas, and precious metals stocks was qualitatively and quantitatively unsuitable for 56-year-old widow with annual income of $25,000 and net worth of $100,000, due to the speculative nature of the securities recommended, concentration of speculative securities placed in widow's portfolio, the use of margin trading, and the excessive number of trades in the account); In re Glenzer, NYSE Disc. Dec., 1994 WL 721660 (Oct. 13, 1994) (finding transactions unsuitable in violation of NYSE Rule 476(a)(6) when a registered representative purchased high yield funds and engaged in aggressive option trading in the account of an elderly couple whose stated investment objective was "safety of principal and income" and who relied upon the registered representative's recommendations due to a lack of financial sophistication).

251 *See* NASD (FINRA) Rule 2310.

> Prior to the execution of a transaction recommended to a non-institutional customer, other than transactions with customers where investments are limited to money market mutual funds, a member shall make reasonable efforts to obtain information concerning: (1) the customer's financial status; (2) the customer's tax status; (3) the customer's investment objectives; and (4) such other information used or considered to be reasonable by such member or registered representative in making recommendations to the customer.

Id. See also Gerald M. Greenberg, 40 S.E.C. 133 (1960) (holding that a broker cannot avoid the duty to make suitable recommendations simply by avoiding knowledge of the customer's financial situation entirely).

Securities Exchange Act Rule 17a-3(a)(17)(i) requires, subject to certain exceptions, broker-dealers to update customer records, including investment objectives, at least every 36 months.

253 *See* Securities Exchange Act Rule 15g-9, 17 CFR 240.15g-9.

In addition, SEC Rule 9b-1 under the Securities Exchange Act[254] establishes a disclosure procedure for options markets to satisfy the information needs of investors in standardized options, foster better investor understanding of standardized options trading, and reduce the costs of issuer compliance with the registration requirements of the Securities Act of 1933. [255] Among other things, SEC Rule 9b-1 obligates an options market to prepare and file with the SEC an options disclosure document ("ODD") that provides certain basic information about the options classes covered by the ODD.[256] Further, Rule 9b-1(d) provides that no broker or dealer shall accept an options order from a customer, or approve the customer's account for the trading of such options, unless the broker or dealer furnishes or has furnished to the customer the options disclosure document.[257]

Activities such as excessive trading, churning, and switching by themselves also can violate obligations under the SRO suitability rules and federal anti-fraud provisions. Moreover, considerations related to suitability may be raised with regard to specific types of accounts such as discretionary accounts and day trading accounts.

A broker-dealer's suitability obligations are different for institutional customers than for non-institutional customers. NASD (FINRA) IM-2310-3 sets out factors that are relevant to the scope of a broker-dealer's suitability obligations in making recommendations to an institutional customer.[258] A broker-dealer fulfills its obligation to determine that a recommendation is suitable for an institutional customer if it has reasonable grounds for concluding that the institutional customer is making independent investment decisions and is capable of independently evaluating investment risk.

Fiduciary Obligations

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254 17 CFR 240.9b-1.

255 See Securities Exchange Act Release Nos. 19055 (September 16, 1982), 47 FR 41950 (September 23, 1982) (adopting Rule 9b-1); 23115 (April 10, 1986), 51 FR 14980 (April 22, 2986) (S7-41-85); and 43461 (October 19, 2000), 65 FR 64137 (October 26, 2000) (adopting amendments to Rule 9b-1) (S7-18-98); *see also* 17 CFR 230.238 (exempting from application of the Securities Act standardized options issued by registered clearing agencies and traded on a registered national securities exchange or registered national securities association); 17 CFR 240.12a-9 (exempting from the registration requirements of the Securities Exchange Act standardized options issued by registered clearing agencies and traded on a registered national securities exchange or registered national securities association); and Securities Act Release No. 8171 and Securities Exchange Act Release No. 47082 (December 23, 2002), 68 FR 188 (January 2, 2003) (S7-29-02) (adopting 17 CFR 230.238, 17 CFR 240.12a-9, and amending 17 CFR 240.9b-1and 17 CFR 240.12h-1).

256 17 CFR 240.9b-1(c).

257 17 CFR 240.9b-1(d).

258 IM-2310-3 states that "for purposes of this interpretation, an institutional customer shall be any entity other than a natural person." Furthermore, while the interpretation is potentially applicable to any institutional customer, the guidance is more appropriately applied to an institutional customer with at least $10 million invested in securities in the aggregate in its portfolio and/or under management. IM-2310-3.

A broker-dealer may have a fiduciary duty under certain circumstances, at times under state common law, which varies by state.[259] This has led courts to reach different conclusions with respect to the facts that create a fiduciary relationship between a broker-dealer and its customer. Generally, courts have held that broker-dealers that exercise discretion or control over customer assets, or have a relationship of trust and confidence with their customers, owe customers a broad fiduciary duty, similar to that imposed on investment advisers.[260] Thus, even for nondiscretionary accounts, broker-dealers may have fiduciary duties with respect to the limited matters entrusted to their discretion.[261]

Other intermediaries under the SEC's regulatory regime, namely investment advisers, are considered fiduciaries. The Advisers Act[262] broadly prohibits advisers from defrauding their clients, which the Supreme Court has construed to impose on them a fiduciary duty to their clients. That fiduciary duty, which is a central proposition of the Advisers Act, requires investment advisers to act in the best interest of clients and to avoid conflicts with clients or, if conflicts cannot be avoided, to provide appropriate disclosure of the conflicts and to obtain client consent. Much of the Advisers Act is designed to enforce that fiduciary duty. Investment advisers, unless exempt, are required to register with the SEC (or the states). All registered investment advisers must, among other things deliver a brochure to clients and prospective clients containing information about their conflicts, fees and business practices; maintain books and records; adopt and implement effective compliance controls administered by a chief compliance officer;

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259 *See Davis v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 906 F.2d 1206, 1215 (8th Cir. 1990).

260 *See, e.g., U.S. v. Skelly*, 442 F.3d 94, 98 (2d Cir. 2006) (fiduciary duty found "most commonly" where "a broker has discretionary authority over the customer's account"); *United States v. Szur*, 289 F. 3d 200, 211 (2d Cir. 2002) ("Although it is true that there 'is no general fiduciary duty inherent in an ordinary broker/customer relationship,' a relationship of trust and confidence does exist between a broker and a customer with respect to those matters that have been entrusted to the broker.") (citations omitted); *Leib v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 461 F. Supp. 951, 953-954 (E.D. Mich. 1978), *aff'd*, 647 F.2d 165 (6th Cir. 1981) (recognizing that a broker who has de facto control over non-discretionary account generally owes customer duties of a fiduciary nature); *Assoc. Randall Bank v. Griffin, Kubik, Stephens & Thompson, Inc.*, 3 F.3d 208, 212 (7th Cir. 1993) (broker is not fiduciary "with respect to accounts over which the customer has the final say"); *MidAmerica Fed. Savings & Loan Ass'n v. Shearson/American Express Inc*., 886 F.2d 1249, 1257 (10th Cir. 1989) (fiduciary relationship exists under Oklahoma law "where trust and confidence are placed by one person in the integrity and fidelity of another"); *Arleen W. Hughes*, Exch. Act Rel. No. 4048, 27 S.E.C. 629 (Feb. 18, 1948) (Commission Opinion), *aff'd sub nom. Hughes v. SEC*, 174 F.2d 969 (D.C. Cir. 1949) (broker-dealer is fiduciary where she created relationship of trust and confidence with her customers); *Paine Webber, Jackson & Curtis, Inc. v. Adams*, 718 P.2d 508 (Colo. 1986); Cheryl Goss Weiss, *A Review of the Historic Foundations of Broker-Dealer Liability for Breach of Fiduciary Duty*, 23 J. Corp. L. 65 (1997). *Restatement (Second) of Torts* § 874 cmt. a (1979) ("A fiduciary relation exists between two persons when one of them is under a duty to act for or to give advice for the benefit of another upon matters within the scope of the relation.").

261 *See Press v. Chemical Inv. Servs. Corp.*, 166 F.3d 529 (2d Cir. 1999) ("the fiduciary relationship that arises between a broker and a customer as a matter of New York common law is limited to matters relevant to the affairs entrusted to the broker.").

262 *See* Advisers Act, *supra* note 177.

seek best execution of clients' transactions; provide only suitable investment advice to their clients; and establish, maintain and enforce written policies and procedures to prevent the misuse of material, nonpublic information. Registered investment advisers that have custody of client assets must take prescribed steps to protect those assets. In addition, the Advisers Act limits the ability of investment advisers to engage in principal transactions with clients (without disclosure and consent before each transaction), or to charge them a performance fee (unless an exemption is available).

Even in those instances where a broker-dealer is not subject to a fiduciary duty, it is subject to a host of regulatory requirements, as explained above.

2. CFTC Regulatory Framework

Customer Protection

Futures and options contracts typically are highly volatile and risky instruments. In the regulatory framework administered by the CFTC, customer protection is furthered by a combination of disclosure and "know your customer" requirements.

CFTC regulations set forth requirements for futures and options risk disclosure statements,[263] and they require disclosure, including similarly specified risk disclosure statements, to pool participants and advisory clients. In 1985, the National Futures Association's ("NFA") Board of Directors adopted a rule premised on the notion that the customer ultimately is in the best position to determine the suitability of commodity interest trading if it receives an understandable disclosure of risks that apply to futures trading from a professional who "knows the customer."[264] The rules require industry professionals to evaluate customer transactions on a customer-by-customer basis rather than on a contract-by-contract or transaction-by-transaction basis (*e.g.*, not an evaluation that the purchase of heating oil futures is suitable for the customer, but the purchase of Treasury futures is not). NFA's know-your-customer rule requires NFA Members to obtain extensive information about each customer's experience, income, net worth and age before opening an account. Based on that information, the Member must make a judgment as to the amount of disclosure that is adequate and must decide whether the customer requires additional risk disclosures beyond the standard disclosures required by CFTC regulations.[265]

Fiduciary Obligations

There are no duties explicitly defined as "fiduciary duties" under the CEA or the CFTC's regulations. The CFTC's case law, however, imposes a range of duties upon intermediaries consistent with their status as persons acting for or on behalf of customers,

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263 CFTC Regulations 1.55 and 33.7, 17 CFR 1.55 and 33.7.

264 NFA Compliance Rule 2-30, Customer Information and Risk Disclosure.

265 *See generally* Roth Testimony, supra, note 221.

and the Commission's Part 166 Customer Protection Rules[266] function as fiduciary regulations.

The CFTC has held that an FCM has an ongoing general duty to disclose material information to a customer, whether the customer asks for it or not.[267] A FCM also has a fiduciary duty to perform any special tasks requested by a customer, unless he expressly disavows the duty.[268] CFTC Regulation 166.2[269] prohibits unauthorized trading, and Regulation 166.3[270] requires CFTC registrants with supervisory duties to exercise them "diligently." The CFTC's churning standard imposes liability upon brokers who trade excessively contrary to the customer's trading objective.[271]

The common law as well imposes fiduciary duties upon those who make decisions regarding the assets of others, and the courts have extended this duty to intermediaries in the commodity futures and option markets, that is, FCMs, CPOs and CTAs. At common law, the extent of an FCM's fiduciary duty ranges from being required to act as the client's alter ego,[272] to merely refraining from making any material misrepresentation and only trading with the prior approval of the client. The courts have determined what duty attaches on a case-by-case basis, depending on the facts, considering, *inter alia*, the nature of the account, the sophistication of the client, and the relationship between the FCM and the client.[273] Although there is no bright-line rule, a discretionary account generally creates a higher level of duty than the obligations created by handling a nondiscretionary account. Because there is no federal standard, many federal courts have deferred to the common law of the state where the case was brought to determine if a fiduciary relationship exists.[274]

The courts have found also that CPOs and certain CTAs may have a fiduciary duty toward their participants and clients.[275] A CTA has a fiduciary duty if it is offering

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266 17 CFR Part 166.

267 *Madel v. Anspacher & Associates, Inc*., [1987–1990 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 24,412 (CFTC Mar. 14, 1989).

268 *Avis v. Shearson Hayden Stone, Inc*., [1980–1982 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 21,379 at 25,831 n.7 (CFTC Apr. 13, 1982).

269 17 CFR 166.2.

270 17 CFR 166.3.

271 *Fields v. Cayman Associates, Ltd.* [1984-1986 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 22,688 at 30,928 (CFTC 1985); *Smith v. Siegel Trading Co.* [1980-82 Transfer Binder] Comm. Fut. L. Rep. ¶ 21,105 at 24,452-53 (CFTC 1980).

272 *United States v. Dial*, 757 F.2d 163, 168 (7th Cir. 1985).

273 *Romano v. Merrill Lynch*, 834 F.2d 523, 530 (5th Cir. 1987).

274 *See e.g. Horn v. Ray E. Friedman & Co.*, 776 F.2d. 777, 779 (8th Cir. 1985).

275 *CFTC v. Savage*, 611 F.2d 270, 285 (9th Cir. 1979); *CFTC v. Equity Financial Group*, 537 F.Supp.2d 677, 697-98 (D.C.N.J. 2008).

personal financial advice.[276] Thus, the fiduciary duty of a CTA does not turn on whether the CTA holds customer funds.

What actions constitute a breach of fiduciary duty are also analyzed on a case-by-case basis. The Seventh Circuit has held that a CTA's failure to inform clients of price changes is not a breach in and of itself,[277] but that an associated person's ("AP")[278] trading ahead of customer accounts constitutes a breach because of an implicit promise to obtain the best price when trading on the behalf of another, which is frustrated by trading ahead of customer accounts, or "front running."[279] The Fifth Circuit has held that an AP had a fiduciary duty but did not breach it when the broker did not tell a financially sophisticated client that he held the opposite position from the client's position.[280] The Ninth Circuit has taken a similar position.[281] The First Circuit has held that an intermediary's failure to disclose material risks associated with trading futures and options was a breach of fiduciary duty to the customer.[282]

3. Analysis of SEC/CFTC Regulatory Frameworks

Customer Protection and Fiduciary Obligations

Financial intermediaries that offer financial advisory services to clients are subject to differing standards under the regulatory schemes of the CFTC and SEC. With respect to suitability, for example, the CFTC requires futures advisers to determine an appropriate level of disclosure particularized to the client based on the "know your customer" information they have obtained.[283] Generally, the "know your customer" rule functions as a business conduct standard and sets forth certain minimum disclosures that would be required in any case.[284] In explaining the rationale behind this disclosure regime, one speaker noted that futures contracts are highly volatile and risky instruments that merit appropriate disclosure at the beginning of the relationship, regardless of whether the customer will rely on recommendations by professional financial planners.[285] However, the speaker noted, because all futures contracts involve risk, the suitability determination is appropriately made on a customer-by-customer basis, rather than trade-

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276 *Commodity Trend Service, Inc. v. CFTC*, 233 F.3d 981, 990 (7th Cir. 2000).

277 *Hlavinka v. CFTC*, 867 F.2d 1029, 1033 (7th Cir. 1989).

278 An AP is a natural person who is associated with an FCM, an IB, a CPO, a CTA, or a leverage transaction merchant in certain capacities. See CFTC Regulation 1.3(aa), 17 CFR 1.3(aa).

279 *Dial*, 757 F.2d at 168-69.

280 *Romano*, 834 F.2d at 530.

281 *Marchese v. Shearson Hayden Stone, Inc.*, 734 F.2d 414, 418 (9th Cir. 1984).

282 *Schofield v. First Commodity Corp.*, 793 F.2d 28, 34-35 (1st Cir. 1986).

283 *NFA Interpretive Notice, NFA Compliance Rule 2-30; Customer Information and Risk Disclosure* (June 1, 1986).

284 *Id*.

285 *Id.*; and Roth Testimony, *supra* note 221.

by-trade.[286] Generally, this approach to suitability is premised on the notion that the customer is in the best position to determine the propriety of futures trading and all that is needed is an understandable disclosure of risks from a futures professional who "knows the customer." An inflexible standard would bar persons from using the futures markets.[287]

In contrast, the SEC's suitability approach requires broker-dealers to determine whether a particular investment recommendation is suitable for a customer, based on customer-specific factors (*e.g.*, the customer's age, financial status, investment objectives, and level of sophistication in financial matters) and factors relating to the securities and investment strategy (*e.g.*, the nature of the securities and the customer's portfolio, the concentration of securities in the customer's portfolio, the use of margin, and the frequency of trading). A broker-dealer must investigate and have adequate information regarding the security it is recommending and ensure that its recommendations are suitable based on the customer's financial situation and needs, as well as other security holdings. In addition to these general suitability and due diligence requirements, particularized suitability, disclosure, and due diligence requirements apply to certain securities products. Generally, these enhanced obligations are intended to address the higher risks associated with these securities products.

The suitability approach in the securities industry is premised on the notion that securities have varying degrees of risk and serve different investment objectives, and that a broker-dealer is in the best position to determine the suitability of a securities transaction for a customer. Disclosure of risks alone is not sufficient to satisfy a broker-dealer's suitability obligation. As a result, the requirement that a suitability determination be made on a recommendation-by-recommendation basis attempts to address the varying risks and objectives of these products and the need to consider and evaluate the suitability of securities products for a customer on a transaction basis.

One panelist at the joint meetings indicated that another reason for the existing differences in approach to customer suitability requirements in the securities and futures industries has to do with the customer base for the relevant products.[288] Specifically, the panelist stated that futures customers are generally sophisticated institutional or commercial investors.[289] Panelists also indicated that, by contrast, the securities markets have a large proportion of retail investors, each with varying levels of sophistication.[290]

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286 *See* Roth Testimony, *supra* note 221 (noting that it does not make sense to say that a customer is suitable for a recommendation to invest in heating oil futures but not in Treasury note futures).

287 *NFA Interpretive Notice, NFA Compliance rule 2-30: Customer Information and Risk Disclosure* (June 1, 1986).

288 *See* Raisler Testimony, *supra* note 52 ("While the securities markets have many smaller, retail customers, commodity market participants tend to be larger, more sophisticated, institutional or commercial participants.").

289 *Id.*

290 *See id; see also* Transcript of Oral Testimony of Craig Donohue, CME Group, CFTC/SEC Joint Meetings on Regulatory Harmonization, September 2, 2009, *supra* note 3 ("We tend to have a much larger retail component to the securities markets as well as the securities options markets.");

Accordingly, some panelists asserted that providing the customer with an appropriate level of disclosure at account opening may be sufficient with respect to futures products, but may not be appropriate for securities products.[291]

However, some have noted that it is inconsistent for broker-dealers, FCMs and IBs to be subject to different standards in situations where the broker-dealers and FCMs are performing similar functions with regard to the customer.[292] One market participant in both the futures and securities industries indicated at the joint meetings that she would support the development of a consistent suitability standard across industries that would protect investors from being sold unsuitable products, regardless of the type of product sold.[293]

Promoting consistent standards is also relevant to the issue of whether financial advisers should be bound by fiduciary duties. Neither the CEA nor the CFTC's regulations explicitly provide for fiduciary obligations. The CFTC's case law, however, imposes a range of duties upon intermediaries consistent with their status as persons acting for or on behalf of customers, and the common law has imposed fiduciary duties in certain circumstances upon FCMs, CPOs and CTAs.[294]

Under the SEC's regulatory regime, investment advisers are considered fiduciaries. While the statutes and regulations do not impose fiduciary obligations on a broker-dealer, a broker-dealer may have a fiduciary duty under certain circumstances under state common law, which varies by state.[295] Generally, courts have held that broker-dealers that exercise discretion or control over customer assets owe customers a broad fiduciary duty, similar to that imposed on investment advisers.[296]

Transcript of Oral Testimony of William Brodsky, Chicago Board Options Exchange, CFTC/SEC Joint meetings on Regulatory Harmonization, September 2, 2009, *supra* note 3 (noting that the securities markets have a broad retail component that he believed is much larger by percentage than what exists in the futures markets, but that the institutional investors are largely the same across the futures and securities markets).

291 *See* Roth Testimony, *supra* note 221; *see also* FIA Comment Letter, *supra* note 59; and Transcript of Oral Testimony of Stephen Luparello, Vice Chairman, FINRA, September 2, 2009, *supra* note 3.

292 *See* Nazareth Testimony, *supra* note 141; see *also* SIFMA Comment Letter, *supra* note 52.

293 Downs Testimony, *supra* note 139.

294 See Section II.E.2, *supra.*

295 *See Davis v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 906 F.2d 1206, 1215 (8th Cir. 1990).

296 *See, e.g., U.S. v. Skelly*, 442 F.3d 94, 98 (2d Cir. 2006) (fiduciary duty found "most commonly" where "a broker has discretionary authority over the customer's account"); *Leib v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 461 F. Supp. 951, 953-954 (E.D. Mich. 1978), *aff'd*, 647 F.2d 165 (6th Cir. 1981); *Assoc. Randall Bank v. Griffin, Kubik, Stephens & Thompson, Inc.*, 3 F.3d 208, 212 (7th Cir. 1993) (broker is not fiduciary "with respect to accounts over which the customer has the final say"); *Paine Webber, Jackson & Curtis, Inc. v. Adams*, 718 P.2d 508 (Colo. 1986); Cheryl Goss Weiss, *A Review of the Historic Foundations of Broker-Dealer Liability for Breach of Fiduciary Duty*, 23 J. Corp. L. 65 (1997).

In light of the current debate on whether to subject broker-dealers who provide personalized financial advice to a fiduciary standard, some have stated that it would be inconsistent for FCMs and IBs to be bound by a lesser standard than an investment adviser that provides a service to a customer that is substantially similar.[297] Thus, if a fiduciary standard were imposed on broker-dealers who provide personalized financial advice, it would seem arbitrary for a different standard to govern FCMs or IBs that perform functionally equivalent services for a customer.[298]

G. Registration and Recordkeeping Requirements of Intermediaries

The CFTC and SEC both have requirements that intermediaries register before conducting business with the public. Each agency imposes specific requirements regarding the procedure and form of application for registration. Thus, financial advisers who are engaged in advising on both futures and securities are subject to both CFTC and SEC registration requirements. In addition, the SEC and CFTC rules impose varying recordkeeping and reporting obligations on these registered intermediaries. Several panelists at the September Meeting suggested that the various requirements applicable to dual registrants should be harmonized and simplified. Below is a discussion of the SEC and CFTC regulatory frameworks for registration and recordkeeping of intermediaries.

1. SEC Regulatory Framework

Generally, a broker-dealer may not begin business until (1) the SEC has granted its registration, (2) the broker-dealer has become a member of an SRO, and (with few exceptions) the SIPC, (3) the broker-dealer complies with applicable state registration and qualification requirements,[299] and (4) its associated persons have satisfied applicable registration and qualification requirements.[300]

The Securities Exchange Act generally requires broker-dealers that effect securities transactions to register with the SEC.[301] In addition, broker-dealers are

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297 *See* Nazareth Testimony, *supra* note 141; and Coffee Testimony, *supra* note 218.

298 *See, e.g.*, Investor Protection Act of 2009, *available at* http://www.treas.gov/press/releases/docs/tg205071009.pdf (draft legislation released by the Treasury Department which would give the SEC authority to require a fiduciary duty for any broker, dealer, or investment adviser who gives investment advice about securities). As discussed above, in some cases, such as discretionary accounts, broker-dealers are already held to a fiduciary standard.

299 Every state has its own requirements for a person conducting business as a broker-dealer.

300 *See* Securities Exchange Act Section 15(b)(1) and (b)(2), 15 U.S.C 78o(b)(1) and (b)(2), and Securities Exchange Act Rule 15b-7-1, 17 CFR 240.15b7-1; *see also* NASD IM-1000-3 Failure to Register Personnel; NASD (FINRA) Rule 1013 ("New Member Application and Interview"), NASD (FINRA) Rule 1021 ("Registration Requirements"), NASD (FINRA) Rule 1031 ("Registration Requirements"); NASD (FINRA) Rule 1041 ("Registration Requirements").

301 Securities Exchange Act Section 15(a), 15 U.S.C. 78o.

required to become members of at least one SRO.[302] Persons applying for broker-dealer registration must complete and file Form BD (Uniform Application for Broker-Dealer Registration) including the required Schedules and Disclosure Reporting Pages, with the Central Registration Depository system ("CRD"), which is used by the SEC, the SROs and the states.[303] In general, Form BD requires information about the background of the applicant, its principals, controlling persons, and employees. Form BD requires information about the type of business in which the applicant proposes to engage, and the identity of the applicant's direct and indirect owners, and other control persons including executive officers, as well as all affiliates engaged in the securities or investment advisory business. Form BD also requires the applicant to disclose whether it or any of its control affiliates has been subject to criminal prosecutions, regulatory actions, or civil actions in connection with any investment-related activity. The applicant also must disclose information about branch offices and arrangements to hold records/funds. In addition, the applicant must disclose whether it or any control affiliate has been subject to a bankruptcy petition, has had a trustee appointed under SIPA,[304] has been denied a bond, or has any unsatisfied judgments or liens.

Once registered, a broker-dealer must keep its Form BD current by amending it promptly when changes occur. Broker-dealers also have financial reporting obligations.

As noted above, even if registered with the SEC, a broker-dealer may not commence business until it satisfies the membership requirements of at least the SRO that it seeks to join. Generally, all registered broker-dealers that deal with the public must become members of FINRA, a registered national securities association. They may also choose to become exchange members.

A broker-dealer generally must register each natural person who is an associated person, other than those persons whose functions are solely clerical or ministerial, with one or more SROs using a Form U4 via CRD. The Form U4 is used to register individuals and to disclose their employment and disciplinary histories. A registered representative must keep his or her Form U4 current by amending it promptly when changes occur. An associated person who effects or participates in effecting securities transactions also must meet qualification requirements, which may include passing a securities qualification exam.[305]

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302 Securities Exchange Act Section 15(b)(8), 15 U.S.C. 78o(b)(8), and Securities Exchange Act Rule 15b9-1, 17 CFR 240.15b9-1.

303 *See* Securities Exchange Act Rule 15b1-1, 17 CFR 240.15b1-1.

304 *See supra* note 104 and accompanying text.

305 *See* Securities Exchange Act Rule 15b7-1, 17 CFR 240.15b7-1; *see also* NASD IM-100-3 ("Failure to Review Personnel"); NASD (FINRA) Rule 1013 ("New Member Application and Interview"); NASD (FINRA) Rule 1021 ("Registration Requirements"); Rule 1031 ("Registration Requirements"); NASD (FINRA) Rule 1041 ("Registration Requirements")

Investment advisers also have registration obligations. Section 202(a)(11) of the Advisers Act[306] generally defines an "investment adviser" as any person or firm that: (1) for compensation; (2) is engaged in the business of; and (3) providing advice to others (or issuing reports of analyses) regarding securities. A person must satisfy all three elements to fall within the definition of "investment adviser." These elements are construed broadly. Section 202(a)(11) of the Advisers Act excludes a number of persons from the definition of "investment adviser," including brokers and dealers, if their performance of advisory services is "solely incidental" to the conduct of their business as broker-dealers, and they do not receive any "special compensation" for their advisory services. In addition, Section 203(b) of the Advisers Act[307] provides a number of exceptions from the registration requirement. Further, pursuant to Section 203A(a) of the Adviser's Act,[308] an adviser is prohibited from registering with the Commission unless the adviser: (1) has assets under management of $25 million or more;[309] (2) advises a registered investment company; (3) maintains its principal office and place of business in a state that does not have an investment adviser statute, or outside of the United States; or (4) is exempt from the prohibition by order or by rule.[310]

An investment adviser registers with the Commission by filing an application for registration on Form ADV. Form ADV has two Parts, 1 and 2, and Part 1 is filed electronically. Form ADV requests information on the adviser's background and business process. The adviser must keep Form ADV current. If material information in the adviser's Form ADV becomes inaccurate, it must be amended promptly; other corrections or updates, including a required annual update, must be made within 90 days of the adviser's fiscal year end.[311]

SEC regulations also impose requirements on registered broker-dealers and investment advisers with respect to recordkeeping and reporting. Section 17(a)(1) of the Securities Exchange Act and Section 204 of the Investment Advisers Act requires broker-dealers and investment advisers, respectively, to make, keep, furnish, and disseminate

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306 15 U.S.C. 80b-2(a)(11).

307 15 U.S.C. 80b-3.

308 15 U.S.C. 80b-3a(a).

309 In order to avoid an investment adviser from having to switch its registration between the states and the SEC shortly after becoming registered, the Commission adopted rule 203A-1(a)(2) that provides a $5 million dollar window until registration is required with the SEC. State-registered advisers may elect to remain registered with the state(s) until they have assets under management of $30 million or more, but they are eligible and may choose to register with the Commission when they have assets under management of $25 million or more. *See* 17 CFR 275.203A-1(a)(2).

310 The following categories of entities are exempt from the prohibition by Rule 203A-2: (1) nationally recognized statistical ratings organizations; (2) pension consultants with respect to plan assets totaling $50 million or more; (3) investment advisers controlling, controlled by, or under common control with an investment adviser registered with the Commission; (4) newly formed advisers expecting to be eligible for Commission registration with 120 days; (5) an investment adviser that would otherwise be required to register in 25 or more states; and (6) internet investment advisers. 17 CFR 275.203A-2.

311 *See* 17 CFR 275.204-1.

reports the SEC deems "necessary or appropriate in the public interest" or "for the protection of investors."[312] Securities Exchange Act Rule 17a-3[313] and Rule 17a-4[314] and Advisers Act Rule 204-2[315] specify minimum requirements with respect to the records that broker-dealers must make, and how long those records and other documents relating to a broker-dealer's business must be kept. For example, Securities Exchange Act Rule 17a-4 specifies the required retention periods for the records, requiring most records to be retained for three years (the first 2 years in an easily accessible place), and others for six years,[316] and Advisers Act Rule 204-2 generally specifies a five year retention period, the first two in an office of the adviser.[317]

2. CFTC Regulatory Framework

The CEA requires that all persons who intermediate commodity interest transactions with members of the retail public register with the CFTC.[318] As defined in the CEA, these persons include FCMs, IBs, CPOs, and CTAs. The primary purposes of registration are to screen an applicant's fitness to engage in the futures business and to identify individuals and organizations whose activities are subject to federal regulation. Individuals and firms that wish to conduct futures-related business with the public must also apply for NFA membership or associate status.

While all applicants must meet certain minimum requirements, there may be additional requirements depending on the category of market intermediary – for example, FCMs and IBs have certain operational requirements because of their access to customer funds, APs have testing and background requirements because, as natural person salespersons, they have direct contact with customers, participants and clients. To register, FCMs, IBs, CPOs and CTAs must disclose business and financial information (including information regarding corporate affiliates), criminal and regulatory history, and contact persons.[319] FCMs and IBs may also be required to submit for approval their procedures and/or materials concerning: (a) anti-money laundering; (b) business continuity; (c) electronic order routing systems (for FCMs) or automated order routing systems (for IBs); (d) promotional materials; (e) supervision of APs; (f) handling of customer complaints; and (g) margins and/or segregation procedures (for FCMs).[320] Similar registration requirements also extend to principals of a registrant, and to floor traders and floor brokers.

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312 15 U.S.C. 78q(a)(1), 15 U.S.C. 80b-4(a).

313 17 CFR 240.17a-3.

314 17 CFR 240.17a-4.

315 17 CFR 275.204-2.

316 17 CFR 275.17a-4.

317 17 CFR 375.204-2(e).

318 CEA Sections 4d(a)(1), 7 U.S.C. 6d(a)(1); 4k(1-3); 4m(1).

319 7 U.S.C. 6n(1)(A)&(B), 7 U.S.C. 12a(2)(D)&(E); 17 CFR 3.10; 17 CFR 3.12.

320 CEA Section 4f(a)(1), 7 U.S.C. 6f(a)(1); 17 CFR 42.2.

CFTC regulations also impose requirements with respect to capital, financial recordkeeping and reporting, transaction recordkeeping and reporting, and customer funds. Pursuant to Regulation 1.31, all books and records required by the CEA and CFTC regulations must be kept for a period of five years and be readily accessible during the first two years of the five-year period. All books and records must be open to inspection by any representative of the CFTC or the U.S. Department of Justice.[321]

3. Analysis of SEC/CFTC Regulatory Frameworks

The CFTC and the SEC have worked in several areas to avoid duplicative regulations with respect to dual registrants. For example, the agencies have promoted uniform capital and related reporting requirements applicable to FCMs and IBs and broker-dealers. The regulations of both agencies require the same capital deductions to be applied to a registrant's proprietary positions in securities and futures, which has enabled FCMs and IBs, if also registered as broker-dealers, to file with the CFTC copies of their SEC-required reports in satisfaction of CFTC reporting requirements. As of the most recent monthly financial reports filed with the CFTC (June 30, 2009), approximately 45% of the total 133 registered FCMs were also registered with the SEC as broker-dealers.

Moreover, certain provisions in the CEA and its regulations provide exemptions for entities already registered with the SEC, and vice versa. For example, one speaker noted that both the Advisers Act[322] and the CEA[323] contain provisions exempting advisers that are registered with the other agency if their business does not "primarily" consist of activities under the supervision of the exempting agency and they do not advise any fund primarily engaged in activities under the supervision of that agency.[324] In a similar vein, CFTC Regulation 4.5[325] provides a definitional exclusion from the CPO (and pool)

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321 17 CFR 1.31

322 *See, e.g., U.S. v. Skelly*, 442 F.3d 94, 98 (2d Cir. 2006) (fiduciary duty found "most commonly" where "a broker has discretionary authority over the customer's account"); *Leib v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 461 F. Supp. 951, 953-954 (E.D. Mich. 1978), *aff'd*, 647 F.2d 165 (6th Cir. 1981) (recognizing that a broker who has de facto control over non-discretionary account generally owes customer duties of a fiduciary nature); *Assoc. Randall Bank v. Griffin, Kubik, Stephens & Thompson, Inc.*, 3 F.3d 208, 212 (7th Cir. 1993) (broker is not fiduciary "with respect to accounts over which the customer has the final say"); *Paine Webber, Jackson & Curtis, Inc. v. Adams*, 718 P.2d 508 (Colo. 1986); Cheryl Goss Weiss, *A Review of the Historic Foundations of Broker-Dealer Liability for Breach of Fiduciary Duty*, 23 J. Corp. L. 65 (1997).

323 7 U.S.C. 1 *et seq*.

324 *See* Testimony of Richard Baker, President and Chief Executive Officer, Managed Funds Association, September 3, 2009 ("Baker Testimony") and Letter from Richard Baker, MFA, to Elizabeth M. Murphy, Secretary, SEC, and David Stawick, Secretary, CFTC, dated September 25, 2009 ("MFA Comment Letter").

325 17 CFR 4.5.

definitions for certain "otherwise regulated persons," which includes investment companies registered under the Investment Company Act.[326]

Some panelists at the September Meeting indicated that further efforts to rationalize regulation for dual registrants were in order. The comments generally raised two separate, inter-related concerns: on the one hand, there should be relief from the burden of complying with duplicative sets of registration, reporting and compliance requirements,[327] but on the other hand, such relief should be appropriately tailored to policy goals such that regulatory gaps are not created.[328]

The CFTC and SEC have similar recordkeeping requirements for FCMs and broker-dealers. Both the SEC and CFTC have specific requirements as to which books and records must be made; how long they are kept; and the manner in which the records are stored. There are, however, distinct differences in the rules. Notably, CFTC regulations require that most records be kept for a period of 5 years, and readily accessible in the first 2 years.[329] The SEC's Rule 17a-4 generally requires that most records be preserved for a period of 3 years, the first 2 in an easily accessible manner, and others to be preserved for 6 years.[330] Several panelists at the September Meetings and commentators urged the Commissions to consider harmonizing these recordkeeping requirements.[331]

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326 *See supra* note 176.

327 *See* Testimony of Eric Baggesen, Senior Investment Officer for Global Equity, CalPERS, September 2, 2009 ("Baggesen Testimony") (recommending a single registration point for market participants); Baker Testimony, *supra* note 324 (suggesting harmonizing registration to avoid duplicate filings); Testimony of Michael Butowsky, Partner, Mayer Brown LLP, September 3, 2009 ("Butowsky Testimony") (questioning the need for completely different registration processes for investment advisers, commodity trading advisors, and commodity pool operators; suggesting that the Commissions should consider whether the books and records requirements of the two agencies should be aligned, whether regulatory examination protocols should be aligned, and whether there should be a common approach to securities and futures position reporting); Downs Testimony, *supra* note 139 (stating that all books and records requirements should be "simple, consistent, and identical across both agencies"); Newedge Comment Letter, *supra* note 143 (suggesting that the CFTC's five-year record retention requirement be adopted uniformly and that FCM electronic storage requirements be modified to conform to broker-dealer requirements); and SIFMA Comment Letter, *supra* note 52 (both agencies should coordinate their net capital rule changes, require the same records and reports where possible and not aggregate existing requirements, and better cooperate and coordinate examinations of dual registrants).

328 *See* Raisler Testimony, *supra* note 52 and Roth Testimony, *supra* note 221.

329 CFTC Regulation 1.31(a)(1), 17 CFR 1.31(a)(1).

330 17 CFR 240.17a-4.

331 *See* Downs Testimony, *supra* note 139 (stating that all books and records requirements should be "simple, consistent, and identical across both agencies"); Newedge Comment Letter, *supra* note 143 (suggesting that the CFTC's five-year record retention requirement be adopted uniformly and that FCM electronic storage requirements be modified to conform to broker-dealer requirements); Butowsky Testimony, *supra* note 327 (suggesting that the Commissions should consider whether the books and records requirements of the two agencies should be aligned); and SIFMA Comment Letter, *supra* note 52 (stating that the Commissions should review their recordkeeping and reporting rules to require the same records and reports wherever possible).

H. Regulation of Cross-Border Activity

Increasing globalization of U.S. financial markets has made the agencies' efforts regarding oversight of cross-border activity critically important. Both agencies have taken steps to encourage the cross-border flow of capital and trading while promoting robust regulatory standards throughout the world. While the basic objectives of the two agencies have been the same, their particular approaches with respect to certain cross-border access issues have differed.

1. SEC Regulatory Framework

Section 5 of the Securities Exchange Act makes it unlawful for any broker, dealer, or exchange "to make use of the mails or any means or instrumentality of interstate commerce for the purpose of using any facility of an exchange within or subject to the jurisdiction of the United States to effect any transaction in a security, or to report any such transaction," unless such exchange is registered as a national securities exchange under Section 6 of the Securities Exchange Act or exempt from such registration upon application with the Commission, based on limited volume.[332] Accordingly, an exchange[333] that wishes to effect any securities transactions in the United States must apply to the SEC for registration as a national securities exchange consistent with Section 6 of the Securities Exchange Act and obtain Commission approval before being able to commence exchange operations. Furthermore, upon approval of its application and thereafter, the exchange is required to operate in compliance with Sections 6 and 19,[334] as well as other sections of the Securities Exchange Act and related rules applicable to registered national securities exchanges. As such, foreign exchanges must comply with the registration requirements under Section 5 and the ongoing regulatory requirements of the Securities Exchange Act if they choose to operate in the United States, absent an exemption. The SEC does not have a separate recognition scheme for foreign exchanges.

Section 15(a) of the Securities Exchange Act generally requires that any broker or dealer using the mails or any means or instrumentality of interstate commerce must register as a broker-dealer with the Commission, unless it is subject to an applicable exception or exemption.[335] Therefore, foreign broker-dealers that induce or attempt to induce securities transactions by any person in the United States, or that use the means or

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332 15 U.S.C. 78e.

333 Section 3(a)(1) of the Securities Exchange Act defines an "exchange" as "any organization, association, or group of persons, whether incorporated or unincorporated, which constitutes, maintains, or provides a market place or facilities for bringing together purchasers and sellers of securities or for otherwise performing with respect to securities the functions commonly performed by a stock exchange as that term is generally understood, and includes the market place and the market facilities maintained by such exchange." 15 U.S.C. 78c(a)(1). *See also* Securities Exchange Act Rule 3b-16, 17 CFR 240.3b-16, regarding the definition of "exchange" in Section 3(a)(1) of the Securities Exchange Act.

334 15 U.S.C. 78f and 78s.

335 15 U.S.C. 78o(a)(1).

instrumentalities of interstate commerce of the United States for this purpose, generally must register with the SEC. Foreign broker-dealers that limit their activities to those permitted under Rule 15a-6 of the Act, however, may be exempt from U.S. broker-dealer registration.[336] This rule provides conditional exemptions from U.S. broker-dealer registration requirements for foreign brokers or dealers that: (1) effect unsolicited transactions; (2) provide research reports to certain institutional investors; (3) effect transactions for certain institutional investors through a U.S. registered broker or dealer; and (4) execute transactions directly with registered brokers or dealers and certain specified other persons.

The SEC has undertaken many initiatives that have been designed to facilitate foreign issuer access to the U.S. securities markets and to U.S. investor's ability to invest in foreign securities. The initiatives include the adoption of:

(i) Rule 144A and Regulation S,[337]
(ii) new approaches governing the registration and deregistration of foreign securities under the Securities Exchange Act,[338]
(iii) IOSCO International Disclosure Standards for foreign registrants,[339]
(iv) accommodations for foreign companies that use International Financial Reporting Standards as issued by the International Accounting Standards Board,[340] and
(v) exemptions which permit certain public rights and exchange offers and business combinations involving foreign companies to proceed without registration or compliance with disclosure or procedural provisions.[341]

The SEC continually strives to enhance international cooperation, raise international regulatory standards, and build international consensus among financial regulators of what constitutes a highly developed, well-functioning marketplace. For instance, the IOSCO, whose membership includes securities regulators throughout the world, has set out 30 "core principles" of securities regulation to be used as a guide to the international regulatory community.[342] In addition, the SEC has entered into over 30

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336 17 CFR 240.15a-6. *See also* Securities Exchange Act Release No. 27017 (effective August 15, 1989), 54 FR 30013

337 17 CFR 230.144A and 17 CFR 230.901 et seq, SEC Release Nos. 33-6862 (Apr 23, 1990) and 33-6863 (Apr 24, 1990).

338 17 CFR 240.12g3-2(b) and 17 CFR 240.12h-6, SEC Release Nos. 34-59465 (Sept 5, 2008) and 34-55540 (Mar 27, 2007).

339 Form 20-F, 17 CFR 249.220f, SEC Release No. 33-7745 (Sept 28, 1999).

340 "Acceptance from Foreign Private Issuers of Financial Statements Prepared in Accordance with International Financial Reporting Standards without Reconciliation to U.S. GAAP", SEC Release No. 33-8879 (Dec 21, 2007) and "First-Time Application of International Financial Reporting Standards," SEC Release 33-8567 (Apr 12, 2005).

341 17 CFR 230.801 and 802, 17 CFR 240.14d-1(c) and (d), SEC Release No 33-7759 (Oct 22, 1999).

342 IOSCO Principles and Objectives of Securities Regulation, May 2003, available at http://www.iosco.org/library/pubdocs/pdf/IOSCOPD154.pdf.

bilateral information-sharing agreements, generally known as MOUs with foreign regulators, many of which are aimed at cooperating in the surveillance and enforcement of securities laws. In 2006, the SEC and UK Financial Services Authority ("FSA") entered into a Memorandum of Understanding concerning consultation, cooperation and the exchange of information related to market oversight and the supervision of financial services firms ("2006 MOU"). The 2006 MOU contained terms for cooperation related to, among other things, inspections of financial services firms.[343] Further, through a "multilateral" information-sharing MOU under the auspices of IOSCO, the SEC has in place an agreement with 55 foreign securities and derivatives regulators to cooperate in enforcement investigations and exchange enforcement and surveillance information.[344]

2. CFTC Regulatory Framework

The CFTC uses a recognition approach in three areas: (1) foreign intermediaries; (2) foreign markets; and (3) foreign clearinghouses clearing OTC instruments. The CFTC does not register or regulate these entities and does not supervise their ongoing operations. The following chart summarizes the CFTC's mutual recognition regime and the means by which it has been implemented.

Foreign Entity	Origin	Mechanism	General Standard
Intermediaries	1987 Rulemaking	Commission Order	A person subject to a comparable regulatory scheme
Markets	1996 Letter	Staff No-Action Letter	A bona fide board of trade subject to substantially equivalent regulatory objectives
Clearinghouses	CFMA	Commission Order	For clearing over-the-counter instruments, a clearinghouse regulated by a foreign regulator that satisfies appropriate standards

[343] In 2008, the SEC and FSA reached an understanding through a side letter to clarify that the terms of the 2006 MOU were extended to cover LCH. Clearnet Limited ("LCH") with respect to its functions as a clearing agency for certain credit default swaps ("CDS") in the U.S. Specifically, in connection with LCH's exemptive relief from registration as a U.S. clearing agency under Section 36 of the Securities Exchange Act, the SEC and the FSA reached an understanding concerning consultation, cooperation and the exchange of information between the FSA and the SEC related to LCH's functions as a clearing agency for certain index-based CDS. In addition, the SEC and FSA expressed their intent to work together to amend the 2006 MOU to expand its scope and modify its terms as appropriate to cover cooperation in regards to clearing organizations and markets in the future.

[344] A list of signatories is available on IOSCO's website (http://www.iosco.org/library/index.cfm?section=mou_siglist).

Intermediaries

The CEA gives the CFTC authority to "develop, if needed, a more formal regulatory program" for the offer and sale of foreign futures contracts in the United States. This statutory provision also states that the CFTC's "rules and regulations may impose different requirements … depending upon the particular foreign board of trade, exchange, or market involved." [345]

The CFTC promulgated regulations in 1987 to establish the regulatory framework for the offer and sale of foreign futures and option contracts in the United States.[346] Under these regulations, the CFTC may exempt from registration foreign brokers intermediating foreign futures and options transactions on behalf of customers located within the U.S. based on substituted compliance with a "comparable" regulatory program. Comparable does not mean identical: the CFTC may conclude that the regulatory program is comparable even though the offshore program does not contain elements precisely identical to that of the Commission's regulatory program.

CFTC Regulation 30.4[347] requires any domestic or foreign person engaged in activities like those of a FCM, IB, CPO, or CTA to register in the appropriate capacity or seek one of the following exemptions from registration:

- Regulation 30.5[348] provides an exemption from registration for any person located outside of the United States who is required to be registered with the CFTC under Part 30 other than a person required to be registered as an FCM. Such a person is required, among other things, to consent to the jurisdiction of the United States courts and the CFTC with respect to dealings with United States customers.
- Regulation 30.10[349] permits a person affected by any of the requirements contained in Part 30 to petition the CFTC for an exemption from such requirements. If the CFTC determines that compliance with the foreign jurisdiction's regulatory program would offer "comparable" protection to persons located in the U.S. and there is an information sharing arrangement between the CFTC and the firm's home country regulator, the CFTC will consider whether to issue an order granting relief to the foreign regulator or exchange, subject to certain conditions. Elements for review include: (1) registration and fitness; (2) minimum financial requirements; (3) protection of customer funds; (4) recordkeeping and reporting requirements; (5) minimum sales practice standards; and (6) compliance.

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345 CEA Section 4(b), 7 U.S.C. 6(b).

346 52 FR 28980 (Aug. 5, 1987).

347 17 CFR 30.4.

348 17 CFR 30.5.

349 17 CFR 30.10.

The CFTC has issued Orders granting exemptions pursuant to Regulation 30.10 to 16 existing foreign exchanges or regulatory authorities.[350]

Markets

The CEA excludes from coverage contracts traded on boards of trade that are "located outside the United States."[351] Accordingly, the CFTC is prohibited from adopting regulations to require registration by FBOTs even if they provide members or other participants located in the United States with direct foreign access to the FBOT's electronic trading and order matching system.[352] Section 4(b) of the Act directs the CFTC to refrain from adopting a regulation that either "requires Commission approval of" or "governs in any way" any FBOT contract, rule, regulation, or action.

There are no statutory criteria that define when a board of trade, exchange, or market is "located outside the United States, its territories or possessions" such that it should not be required to register as a DCM. CFTC staff has been making such determinations through a no-action letter process. To date, CFTC staff has issued no-action letters to 21 FBOTs.[353] Staff analyzes requests for no-action relief by analyzing whether the FBOT is a "bona fide" foreign exchange that is subject to a regulatory regime that enforces objectives that are substantially equivalent to those enforced by the CFTC. The criteria employed include whether the exchange has the attributes of an established and organized exchange, adheres to appropriate rules prohibiting abusive trading practices, has been authorized by a regulatory process that examines customer and market protections, and is subject to continued oversight by a regulator that has power to intervene and share information with the CFTC.

The CFTC confirmed the no-action process in a Statement of Policy on FBOTs in 2006,[354] and some issues regarding FBOT contracts linked to contracts traded on CFTC-

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350 These jurisdictions are: Australia, Brazil, Canada, France, Germany, Japan, New Zealand, Singapore, Spain, Taiwan, and the United Kingdom. *See also* 57 Fed. Reg. 49,644 (Nov. 3, 1992) (permitting limited marketing of foreign futures and foreign option products to certain governmental and institutional customers located in the U.S.); and 59 Fed. Reg. 42,156 (Aug. 17, 1994) (expanding the 1992 relief to conduct directed toward SEC-accredited investors).

351 CEA Section 4(a), 7 U.S.C. 6(a).

352 The CFTC has supported legislative amendments to the Act to provide for such authority. The Administration presented Congress with the Over-the-Counter Derivatives Markets Act of 2009, a comprehensive package of financial regulatory reform legislation (focused primarily on the regulation of OTC derivatives), on August 11, 2009. The CFTC actively participated in the development of the legislation, which is posted on Treasury's website at http://www.financialstability.gov/docs/regulatoryreform/titleVII.pdf. Section 725 of the legislation addresses FBOTs, particularly with respect to contracts linked to those traded on CFTC registered entities.

353 The jurisdictions are: Australia, Brazil, Canada, Dubai, France, Germany, Hong Kong, Japan, Mexico, the Netherlands, Norway, Singapore, Spain, and the United Kingdom.

354 Boards of Trade Located Outside of the United States and No-Action Relief from the Requirement to Become a Designated Contract Market or Derivatives Transaction Execution Facility, 71 Fed. Reg. 64,443 (November 2, 2006); *see also* Notice of Revision of Commission Policy Regarding

regulated exchanges were further addressed in another Statement of Policy in 2009.[355] Most recently, the CFTC announced additional amendments to the terms under which an FBOT is permitted to make its electronic trading and order matching system available to exchange members and other participants located in the U.S.[356]

Clearinghouses

The CFTC does not recognize foreign regulation in the context of non-U.S. clearinghouses operating as DCOs. Section 5b of the Act requires such entities to register as DCOs.[357] The CEA does not exempt from registration, nor does it provide any alternate category of registration for, DCOs that are based outside the United States notwithstanding supervision by a foreign regulator.

Under Section 409(b)(3) of the Federal Deposit Insurance Corporation Improvement Act of 1991 (as amended by the CFMA) ("FDICIA"),[358] a clearinghouse may operate as a multilateral clearing organization ("MCO") in the United States with respect to OTC instruments if it is supervised by a foreign financial regulator that the CFTC has determined satisfies "appropriate" standards. The CFTC has issued four MCO Orders.[359] In addition to considering the clearinghouse's risk management procedures and existing information-sharing arrangements with the foreign regulator, the CFTC primarily considers three factors: (1) whether the regulatory regime substantially corresponds with the Act, including the core principles for DCOs in Section 5b, and CFTC regulations; (2) whether the supervision provided by the regulator with respect to clearing activities substantially corresponds with the CFTC's supervision of DCOs; and (3) whether the regulator's supervision substantially comports with IOSCO's Principles and Objectives of Securities Regulation.

In addressing the oversight of cross-border clearinghouses, the CFTC has recognized that a tailored cooperative arrangement would provide the CFTC with an important tool in overseeing such entities. On September 14, 2009, the CFTC entered

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the Listing of New Futures and Option Contracts by Foreign Boards of Trade that Have Received Staff No-Action Relief to Provide Direct Access to their Automated Trading Systems from Locations in the United States, 71 Fed. Reg. 19,877 (April 18, 2006); corrected at 71 Fed. Reg. 21,003 (April 24, 2006).

355 Notice of Additional Conditions on the No-Action Relief When Foreign Boards of Trade That Have Received Staff No-Action Relief to Permit Direct Access to Their Automated Trading Systems from Locations in the United States List for Trading from the U.S. Linked Futures and Option Contracts and a Revision of Commission Policy Regarding the Listing of Certain New Option Contracts, 74 Fed. Reg. 3,570 (January 21, 2009).

356 CFTC Announces Amendments to ICE Futures Europe's Foreign Access Relief – New Conditions Strengthen Oversight of Energy Markets, http://www.cftc.gov/newsroom/generalpressreleases/2009/pr5697-09.html.

357 7 U.S.C. 7a-1.

358 12 U.S.C. 4422(b)(3).

359 The four jurisdictions are: Canada, Germany, Norway, and the United Kingdom.

into a MOU Between the Commission and the FSA Concerning Cooperation and the Exchange of Information Related to the Supervision of Cross-Border Clearinghouses. The MOU establishes a framework for close cooperation, calls for sharing material information, provides for on-site visits, and contemplates ongoing discussions between the CFTC and FSA. In addition, the arrangement provides for the request of information related to each authority's statutory functions and efforts to ensure compliance with its laws or regulations.

International Cooperation

In a manner very similar to the SEC, the CFTC works on enhancing international cooperation, raising international regulatory standards, and building international consensus among financial regulators. The CFTC is an active participant in IOSCO and has entered into the MMOU for cooperating in enforcement investigations, and exchanging enforcement and surveillance information. In addition, the CFTC has entered into more than 30 bilateral information-sharing arrangements that support surveillance, enforcement, and regulatory cooperation. The CFTC also routinely has discussions and dialogue with its foreign counterparts.

3. Analysis of SEC/CFTC Regulatory Frameworks

As described above, under the SEC approach foreign exchanges wishing to engage in a securities business in the United States must comply with the registration requirements under Section 5 of the Securities Exchange Act before operating in the United States. The CFTC, however, when its staff makes certain findings in a request for no-action relief, permits FBOTs, subject to appropriate conditions, to provide their members or participants in the United States with access to their electronic trading systems without seeking designation under the CEA. As a result of concerns regarding the CFTC's oversight capabilities over FBOTs that provide access to persons in the United States, legislation proposed by the Treasury Department contains provisions permitting the CFTC to require a statutory registration category for such entities.

With regard to intermediaries, foreign broker-dealers' interaction with United States investors in securities transactions is facilitated primarily through the exemptions from United States broker-dealer registration offered by Securities Exchange Act Rule 15a-6. Foreign broker-dealers relying on such an exemption must comply with the conditions of the exemption and limit their activities to those permitted under Rule 15a-6. The CFTC's regulatory regime allows for broader cross-border intermediary access. Under Part 30 of the CFTC's regulations, the CFTC may grant an exemption from registration to any foreign broker offering or selling foreign futures or options based upon substituted compliance with a comparable regulatory program.

Several panelists at the September Meeting raised the issue of international cooperation and cross-border access.[360] In particular, panelists urged the agencies to

[360] *See* Leibowitz Testimony, *supra* note 51; Short Testimony, *supra* note 93; Reitz Testimony, *supra* note 51; Raisler Testimony, *supra* note 52; Downs Testimony, *supra* note 139; and Testimony of

continue to cooperate with their foreign counterparts and to seek global regulatory harmonization, especially with regard to the regulation of OTC derivatives. Some panelists also indicated a preference for aligning the SEC and CFTC regimes by expanding cross-border access with respect to securities transactions, while others suggested that this initiative need not be pursued as a top priority at this time. Another panelist highlighted the need to enhance cross-border harmonization to prevent regulatory arbitrage.

Both agencies have engaged in numerous international cooperative efforts in recent years with the goal of improving regulatory coordination. The SEC and CFTC intend to continue to enhance their coordination and cooperation efforts with foreign regulators. The Administration's initiatives to accomplish the objectives of raising international regulatory standards and improving international cooperation outlined in the Treasury's White Paper will further enhance the agencies' efforts. As the international community works towards reaching consensus on core areas of regulation, the agencies will work together to further their mutual goals of strengthening international regulatory standards and collaboration.

III. Recommendations

The SEC and the CFTC's examination of each agency's regulatory regime, and statements and commentary from the September Meeting have identified areas of difference between the two agencies' regulatory frameworks. Many of these differences are due to specific attributes of the securities and futures markets. Thus, any effort to harmonize the two regulatory regimes must take into account the particular characteristics of the two markets and products that they offer. Regulations must be tailored for the purposes and objectives of the specific market in question.

At the same time, the agencies share the common objectives of protecting investors, ensuring market integrity, and promoting price transparency. Accordingly, the Commissions present recommendations that will allow them to better coordinate and harmonize their regulatory systems. These recommendations, which address areas ranging from exchange rule-making, product review, enforcement and compliance by dual registrants, are designed to fill regulatory gaps, eliminate inconsistent oversight, and promote greater collaboration.

A. Facilitate Portfolio Margining

The Report recommends legislation to facilitate the holding of (i) futures products in an SRO securities portfolio margin account and (ii) securities options, SFPs, and certain other securities derivatives in a futures portfolio margin account. Panelists

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Michael Connolly, Vice Chairman, Board of Directors, Association of Financial Professionals, September 3, 2009 ("Connolly Testimony"); *see also* Transcript of Oral Testimony from Craig Donohue, Chief Executive Officer, CME Group, Inc., September 2, 2009, *supra* note 3; *see also* Newedge Comment Letter, *supra* note 143; FIA Comment Letter, *supra* note 59; and SIFMA Comment Letter, *supra* note 52.

identified portfolio margining as a significant area for harmonization and agreed that portfolio margining is important to U.S. competitiveness. The Commissions acknowledge that industry participants are currently developing different approaches to achieving the benefits of portfolio margining, including the two account (or "two pot") model.

To achieve more fully the benefits of risk-based portfolio margining, the Commissions would support legislation that confers upon customers the choice of portfolio margining in a single futures or securities account at a dually-registered broker-dealer/FCM. Specifically, the Commissions would support legislation that: (i) clarifies that security options, SFPs, and certain other securities derivatives may be held in a futures account and that, in the event of FCM insolvency, customer claims would not be protected under SIPA, but would be resolved under the futures insolvency regime; (ii) clarifies that futures may be held in securities portfolio margin accounts and that the CFTC may waive its segregation requirements with respect to such futures; and (iii) extend SIPA protection to customer claims based on any futures and options on futures (and certain other securities-based derivatives) held in a securities portfolio margin account, together with the collateral held to margin those positions. The Commissions will work together to foster agreements among futures and options clearing houses that extend the benefits of portfolio margining to clearing house margin and, in that connection, will provide any appropriate exemptive relief.

In addition, the Commissions should undertake to review their existing customer protection, margin and any other relevant regulations to determine whether any rule changes or exemptive relief would be necessary to achieve the full benefits of risk-based portfolio margining. The Commissions should also undertake, with input from experts, the industry, and the public, to explore whether further modifications to portfolio margining, including adoption of a one account model that would accommodate all financial instruments and all broker-dealers and FCMs, would be in the public interest.

B. Facilitate Product Approval Process and Provide Legal Certainty

The Report recommends legislation that would provide a process for expedited judicial review of jurisdictional matters regarding new products. Per the 2008 MOU, the Commissions "acknowledge that there may be instances in which novel derivative products may reflect elements of both securities and commodity futures or options." The experience of past disagreement between the CFTC and SEC regarding jurisdiction over particular products was noted at the September Meeting. Despite the agencies best efforts, the potential for future disagreement exists. Accordingly, the SEC and the CFTC support legislation to establish and clarify: (i) legal certainty with respect to product listings and their use of exemptive authority; and (ii) a review process to ensure that any jurisdictional dispute is resolved by the Commissions against a firm timeline.

1. The ability of the SEC and CFTC to resolve the legal uncertainty regarding particular products has been affected by the agencies' statutory authority. The SEC and CFTC would support legislation that: (i) allows the CFTC to exercise

jurisdiction over an instrument that the SEC exempts, conditionally or unconditionally, pursuant to its authority under the Securities Exchange Act; and (ii) clarifies that the SEC may exercise authority over a securities-related instrument that the CFTC has exempted pursuant to its power under the CEA. Exemptive orders issued by the SEC are not required to expressly state that a product is or is not a security.

2. There should be a timeline for the two agencies either to use their exemptive authority or otherwise come to agreement on the status of a product. The CFTC and the SEC would support legislation that establishes a process along the following lines: (i) if either agency receives an application for listing of a novel derivative product that may have elements of both securities and commodity futures or options, agency staff shall immediately notify the other agency's Secretary and forward a copy of such application; (ii) upon a request by the Chairman or Commission of either agency, the other agency's Commission shall, within 120 days of such request, by order determine whether the Commission intends to assert jurisdiction; (iii) in the case that one agency does not agree with the other agency's determination regarding the status of a product, it may petition a United States Court of Appeals for expedited review.

Congress may also want to consider other methods for resolving disagreements between the agencies.

C. Enhance CFTC Authority Over Exchange Compliance with the CEA

The Report recommends legislation to enhance CFTC authority over exchange and clearinghouse compliance with the CEA. The Commodity Futures Modernization Act significantly limited the CFTC's authority over the rules of exchanges and clearinghouses subject to its oversight. The CFTC does not have clear authority, for example, to set rules for risk management for exchanges and clearinghouses. The CFTC's authority contrasts with the authority of other regulators, such as the SEC or regulators in foreign jurisdictions. In the near future, however, the CFTC will be expected to regulate not only the futures markets, but also a large section of what currently is the over-the-counter market for derivatives and possibly emissions trading. Absent clear rulemaking authority, the CFTC is limited in its ability to enforce core principles, to adapt to market conditions and international standards, and to protect the public. To provide the CFTC with sufficient ability to ensure that exchanges and clearinghouses regulated under its authority are operating within the principles, rules and regulations established under the CEA, the CEA should be amended to provide the CFTC with clear authority with respect to exchange and clearinghouse rules that the CFTC finds are necessary for them to comply with the CEA. The CEA should be amended to: (i) clarify the CFTC's rulemaking authority to determine the appropriate manner by which an exchange or clearinghouse may comply with the CEA; (ii) extend from one to ten business days, with a possible extension of another 90 days for novel or complex rules or products or in other appropriate circumstances, the period for the CFTC to review new and amended rules or products proposed by an exchange or clearinghouse; and (iii) provide the CFTC with clear authority to bring an enforcement action against an exchange or clearinghouse for violation of a core principle in the same manner as it

would any other enforcement action alleging a violation of the CEA or CFTC rules. Provisions for these changes are part of Title VII of the Administration's proposed financial regulatory reform legislation. In addition, the CEA currently provides that exchange rules shall be approved unless the CFTC concludes that the rule "would violate" the CEA. To provide greater oversight authority, the CEA should be amended to provide, as does Section 19(b) of the Securities Exchange Act with respect to the SEC's authority, that the CFTC shall approve a proposed rule change if it finds that the change is consistent with the statute and regulations, but that the proposed rule change shall be disapproved in the absence of such a finding.

D. Review Approach to Cross Border Access

The Report recommends that the SEC review its approach to cross-border access to determine whether greater efficiencies could be achieved with respect to cross-border transactions in securities consistent with the protection of investors and the public interest. As described above, under the SEC approach foreign exchanges seeking to do business in the United States must comply with the applicable registration requirements under the Securities Exchange Act. In addition, foreign broker-dealers' interaction with U.S. investors is facilitated primarily through the exemptions from U.S. broker-dealer registration offered by Securities Exchange Act Rule 15a-6. As noted above, several panelists at the agencies' September Meeting indicated a preference for aligning the SEC and CFTC regimes by expanding cross-border access with respect to securities transactions.

The SEC intends to undertake a focused review of its approach to cross-border access. In particular, the SEC intends to consider whether its current approach could be modified to achieve greater efficiencies regarding cross-border securities transactions without impairing investor protections. For instance, in connection with its review, the SEC would consider whether limited revisions to the provisions of Rule 15a-6 regarding the interaction of United States investors with foreign broker-dealers may be appropriate.

E. Statutory Recognition Regime for Foreign Boards of Trade

The Report recommends legislation to empower the CFTC to require foreign boards of trade to register with the CFTC. The CFTC has been concerned that some FBOTs that grant access to their trading facilities to persons located inside the United States may not have certain rules and protections that the CFTC considers necessary for maintaining the integrity of markets and orderly trading. The CFTC currently provides no action relief to FBOTs that have comparable regulatory requirements and is based on reliance of the foreign regulator. Because there is no statutory registration requirement under the CEA for FBOTs, the CFTC's authority to oversee trading by United States entities abroad, and phenomena such as the so-called "London loophole," is limited. Therefore, the CFTC recommends that the CEA be amended to grant the agency authority to require registration of any FBOT that seeks to provide direct access to members or other participants located in the United States and, when appropriate, relying on the foreign regulator to avoid duplicative regulation. The CFTC also recommends that

the amendments to the CEA provide that FBOTs may not be registered unless they meet certain standards that enhance transparency and market integrity, including daily public dissemination of trading information, authority to set position limits to prevent manipulation and excessive speculation, enforcement authority over manipulative conduct, and provision of information to the CFTC. This recommendation is consistent with provisions in Title VII of the Administration's proposed financial regulatory reform legislation.

F. Establish a Uniform Fiduciary Standard for Those Providing Investment Advisory Services

The Report recommends legislation that would impose a uniform fiduciary duty on intermediaries who provide similar investment advisory services regarding futures or securities. Whether regulated by the CFTC or by the SEC, intermediaries are subject to different standards in their interactions with clients. Although some are held to a fiduciary duty standard, others are not, except in certain particular circumstances defined by state common law. For instance, investment advisers are currently subject to a fiduciary standard. When providing similar investment advisory services, other intermediaries also should be subject to this standard.

Therefore, consistent with Title IX of the Administration's financial regulatory reform legislation, which seeks to establish a uniform standard of conduct for broker-dealers and investment advisers, the agencies recommend that a consistent standard apply to any CTA, FCM, IB, broker-dealer, or investment adviser who provides similar investment advisory services. The SEC and the CFTC support initiatives to align a high standard of customer care for intermediaries across financial products, recognizing that the behavior of an intermediary acting in the best interest of its client may vary based on facts and circumstances, including the nature of the customer relationship and the services provided. Robust customer protections should apply equally and uniformly across the securities and futures markets.

G. Align Record Retention Requirements for Intermediaries

The Report recommends that the SEC and the CFTC undertake to align their record retention requirements for intermediaries by harmonizing the length of time records are required to be maintained. The SEC and the CFTC have different record retention requirements for intermediaries. Panelists and commentators suggested that the record retention rules be harmonized to decrease burdens resulting from disparities and suggested that the agencies jointly review the governing rules in this area and consider aligning their requirements. The SEC intends to review its current three (3) and six (6) year record retention requirements and consider, as appropriate, rule changes that would harmonize these requirements with the five (5) year record retention requirements the CFTC makes applicable to CFTC registrants.

H. Align Customer Risk Disclosure Documents

The Report recommends that the agencies provide greater consistency in their customer risk disclosure documents. Pursuant to SEC rules, an equity options market must file an ODD that provides certain basic information about the options classes covered by the ODD. In addition, a broker-dealer must provide the ODD before accepting an options order from a customer or approving the customer's account for the trading of options. CFTC regulations set forth requirements for commodity futures and options risk disclosure statements, and they require disclosure, including similarly specified risk disclosure statements, to pool participants and advisory clients.

At the September Meeting, a panelist contrasted the CFTC and SEC disclosure documents, noting that whereas the former is between two (2) to three (3) pages in length, the latter can be over 100 pages. The CFTC's disclosure documents were thus cited as a model to follow because of their brevity and accessibility. The SEC intends to review the current ODD to determine whether a customer disclosure document more akin to that which is used for futures products would be appropriate and consistent with the protection of investors and the public interest. The SEC anticipates considering what format and requirements may be necessary to promote a firm understanding of the characteristics and risks of various option products by investors. In doing so, the SEC plans to look to, among other things, disclosures provided in registered options offerings, including greater use of plain English, and to futures disclosure documents, to describe the products and their particular risks.

I. Align Specific Private Fund Reporting Requirements

The Report recommends efforts to align specific private fund reporting requirements. The CFTC and the SEC should review regulatory requirements applicable to investment advisers and commodity trading advisors/commodity pool operators with respect to private funds to eliminate, as appropriate, any inconsistent or conflicting provisions regarding: (i) the use of performance track records; (ii) requirements applicable to investor reports (including the financial statements often used by registered investment advisers to comply with the Advisers Act custody rule and the financial statements delivered to investors by commodity pool operators); and (iii) recordkeeping requirements.

J. Expand CFTC Conflict of Interest Prevention Authority

The Report recommends legislation to expand the CFTC's conflict of interest prevention authority. Legislation should be enacted to authorize the CFTC to require FCMs and IBs to implement conflict of interest procedures that would separate the activities of persons in a firm engaged in research or analysis of commodity prices from those involved in trading or clearing activities. Provisions for such change, patterned on those enacted for securities firms in Sarbanes-Oxley, are part of Title VII of the Administration's proposed financial regulatory reform legislation.

K. Enhance Whistleblower Protections

The Report recommends legislation on whistleblower protections. Consistent with Title IX of the Administration's proposed financial regulatory reform legislation, legislation should be enacted to encourage whistleblowers to come forward with relevant information to authorities in both SEC and CFTC registered markets. Specifically, the legislation should provide for: (i) rewards for legitimate whistleblowing; and (ii) protection of whistleblowers.

L. Clarify the CEA's Restitution Remedy

The Report recommends legislation that would address customer restitution in CFTC enforcement actions. The CFTC currently has express authority to seek restitution for investor losses in administrative proceedings. However, the legislation should clarify that restitution in civil actions is defined in terms of the losses sustained by persons as a result of the unlawful conduct.

M. Enhance the CFTC's Disruptive Trading Practices Authority

The Report recommends legislation to enhance the CFTC's authority over disruptive trading practices. Experience shows that certain practices are so disruptive to trading in the futures markets that they should be presumptively prohibited. Accordingly, legislation should be enacted to enhance the CFTC's enforcement authorities with respect to certain disruptive practices that undermine market integrity and the price formation process in the futures markets.

N. Expand the Scope of Insider Trading Prohibitions Under the CEA

The Report recommends legislation to expand the scope of insider trading prohibitions under the CEA. Legislation should be enacted to expand the scope of insider trading coverage under the CEA. Currently, for example, misuse of non-public information from many government agencies, including the Federal Reserve, the Treasury Department, the Department of Agriculture and other government bodies, to trade in the futures markets is not punishable. The CEA should be amended to make unlawful the misappropriation and trading on the basis of material non-public information from any governmental authority.

O. Grant the SEC Specific Statutory Authority for Aiding and Abetting Under the Securities Act and the Investment Company Act

The Report recommends legislation that would grant the SEC specific statutory authority for aiding and abetting under the Securities Act and the Investment Company Act. The CFTC has specific statutory enforcement authority for aiding and abetting all violations of the CEA and CFTC rules and regulations, while the SEC has specific statutory authority for aiding and abetting only under the Securities Exchange Act and the Investment Advisers Act and not under the Securities Act or the Investment Company Act. Expanding the SEC's statutory authority to allow the SEC to bring actions for

aiding and abetting violations of the Securities Act and the Investment Company Act would close the gap between the SEC and CFTC's regulatory regimes.

P. Create a Joint Advisory Committee

The Report recommends legislation to authorize the SEC and the CFTC to jointly form, fund, and operate a Joint Advisory Committee that would be tasked with considering and developing solutions to emerging and ongoing issues of common interest in the futures and securities markets. Specifically, the Joint Advisory Committee would identify emerging regulatory risks and assess and quantify their implications for investors and other market participants, and provide recommendations for solutions. The committee would serve as a vehicle for discussion and communication on regulatory issues of mutual concerns affecting CFTC and SEC regulated markets, and the industry generally, and their effect on the SEC's and CFTC's statutory responsibilities.

Members of the Joint Advisory Committee would be appointed by the Chairmen of the SEC and CFTC. Members would include both SEC and CFTC members, as well as experts and industry participants. A SEC and a CFTC member would serve as co-chairmen of the committee. Such a Joint Advisory Committee would be a valuable resource for continuing to further the Administration's recommendation on harmonization.

Q. Create a Joint Agency Enforcement Task Force

The Report recommends that the agencies create a Joint Agency Enforcement Task Force to harness synergies from shared market surveillance data, improve market oversight, enhance enforcement, and relieve duplicative regulatory burdens. A number of panelists at the September Meeting endorsed creation of a task force that would consist of staff from each agency to coordinate and develop processes for conducting joint investigations in response to events that affect both the securities and futures markets. The task force would prepare and offer training programs for the staffs of both agencies, develop enforcement and examination standards and protocols, and coordinate information sharing. The task force also would oversee temporary details of personnel between the agencies to assist in furthering the aforementioned objectives. The Commissions believe that the creation of a Joint Agency Enforcement Task Force will help eliminate inefficiencies, and ensure comprehensive and consistent fraud and manipulation detection across the two marketplaces.

R. Establish a Cross-Agency Training Program

The Report recommends that the SEC and the CFTC should establish a joint cross-agency training program for staff. The SEC recently enhanced its training for SEC staff and has been requiring its examiners to obtain certification through the Association of Certified Fraud Examiners training program. With rapidly evolving global financial markets and technology, and the convergence of marketplaces and market participants, the number and complexity of matters where both agencies have enforcement jurisdiction

and interest will continue to grow. Accordingly, the Commissions believe that joint training programs for enforcement personnel would be highly beneficial. The training program would be for staff at both agencies, and would focus on enforcement matters.

S. Develop a Program for Sharing Staff Through Detail Assignments

The Report recommends to develop a program for the regular sharing of staff through detail assignments. The agencies anticipate that, through this program, each year several staff from each agency will have the opportunity to work at the other agency through temporary detail positions for a specified period of time. As financial products grow more complex, and as financial institutions and markets continue to consolidate and expand their global reach, it is becoming ever more imperative for the staffs of each agency to have a thorough understanding of both the securities and futures markets in order to perform effectively. Implementing a program where staff engages in a rotation between the two agencies will allow for greater collaboration and coordination between the two agencies. Further, it will help foster understanding and appreciation for the unique aspects of the markets and products for which both agencies are responsible.

T. Create a Joint Information Technology Task Force

The Report recommends that the agencies develop a Joint Information Technology Task Force to pursue linking information on CFTC and SEC regulated persons made available to the public and such other information as the Commissions jointly find useful and appropriate in the public interest. Linking publicly-filed information and such other information as the Commissions jointly find useful and appropriate in the public interest residing with the two agencies would promote transparency and facilitate the use and understanding of such information by providing a comprehensive, consolidated database on persons and entities regulated by the SEC and the CFTC. An integrated database would assist the staff of both agencies in conducting investigations, examinations, enforcement matters, and market surveillance activities. The task force should also explore linking or coordinating the NFA BASICdatabase and IARD, which would make it easier for investors and customers to find registration and disciplinary information for an adviser. Such linkage of information on the professional background of current and former securities and futures firms and brokers would further the same objectives. Accordingly, the CFTC and SEC recommend formation of a joint agency task force on information technology.