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Commodity Futures Trading Commission
Hearings on Regulation of Intermediaries
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The Commodity Futures Trading Commission (CFTC) should adopt a "core principles" approach to the regulation of Futures Commission Merchants (FCMs) analogous to its recently adopted regulation for contract markets. These core principles should reflect the role of intermediaries in the marketplace, the public policy interest of preventing systemic risk, and a recognition that only a very few FCMs act exclusively in that capacity and thus regulation and supervision is shared with other authorities. These core principles should recognize the following points:

- **Transparent Financial Reporting**: The single most important decision that an investor makes with respect to participation in the futures markets is the choice of FCM to carry its funds and positions. Consequently, an ability to easily compare and contrast the financial strength of various FCMs is fundamental. Information about required and surplus regulatory capital, as well as timely access to audited financial statements of FCMs and audited and quarterly reports on the parents of FCMs are vital to investors and potential investors.

  The Commission has taken the lead in providing transparent information to investors. I refer to the comparative information on FCM regulatory capital published quarterly on the CFTC's website under the title "Selected FCM Financial Data." To my knowledge, there is nothing comparable, particularly in such an easy to use format, from other US regulatory agencies. Still, this service could be taken several steps further. For example, with a "hot link" to the Securities and Exchange Commission's (SEC's) EDGAR service so that the "10-Q" reports of the publicly traded parents of FCMs could be easily accessed. A joint listing with the SEC to include similar information for broker/dealers would also be useful for investors.

- **Risk Management and Regulatory Capital:** Sound risk management and internal control procedures, backed up by a regulatory capital regime that directly relates capital requirements to market and operational risk is the only effective means to control systemic risk. Today, the balkanized regulatory structure in the United States severely limits the effectiveness of supervision of internal control and risk management programs at FCMs and other intermediaries, but this deficiency is not inherent. Working with the SEC and the appropriate banking supervisors, the Commission should strongly encourage self-regulatory organizations and other supervisory authorities to perform joint and simultaneous

[1] The opinions expressed are those of the author and do not necessarily represent the views of Morgan Stanley.

reviews of risk management and internal control procedures across all US regulated entities of a financial services company.

Notwithstanding published staff recommendations as recent as April 2001[2], the Commission does not have a risk based regulatory capital regime. Once such a regime is adopted, the Commission should carefully review its regulatory capital requirements for dual registrants in light of the regulatory capital requirements of the SEC. If those two regulatory capital regimes indeed measure different risks, then it is not sensible to have the total regulatory capital requirement of a dual registrant be the greater of the SEC or CFTC requirements. If the risks are really different, it must be the case that the "right" answer is the sum of the two requirements.

- **FCMs are not regulators**: The Commission's regulations need to be modified to recognize that FCMs do not have the ability to govern the market behavior of their customers. Customers understand that an FCM must take certain steps to protect itself from unlimited counterparty exposure through mechanisms such as limiting credit exposure (e.g. through margin requirements) and limiting legal exposure (e.g. through client identification and documentation requirements). It is much more difficult for customers to understand why FCMs should be involved in things like the oversight of their investment management practices. This is even more challenging where an affiliate of the FCM may be a competitor of the customer, as is frequently today the case. If there is a legitimate public policy reason to limit the investment management practices of various types of investment advisors and/or investment managers, the only intellectually honest means of carrying out that policy is to impose the limitation directly on investment advisors and investment managers. Lack of jurisdiction by a regulatory authority over investment advisors/managers in certain domiciles or of certain types should be an indictment of the legitimacy of the public policy goal, not an excuse to impose regulatory jeopardy on uninvolved and uninterested intermediaries.

  The current "bunched order" processing rules seek to have FCMs intervene between an investment advisor/manager and its clients in the non-preferential allocation of executions to accounts. This rule puts a completely unrealistic burden on an FCM and should be abolished.

- **Relations with the Securities and Exchange Commission:** While many may lament the amount of time it has taken to craft a workable regulatory framework for the trading of security futures, I think it more appropriate to applaud the remarkable progress that has been made by the staffs of the two Commissions. The "world view" of the two organizations is understandably but dramatically different. Congress clearly took the easy way out, and left the reconciliation of

[2] "Review of SRO Risk-Based Capital Requirements and Comparison to the Commission's Minimum Net Capital Requirements," Division of Trading and Markets, Commodity Futures Trading Commission, April 2001, p.3.

these two fundamentally different approaches to market oversight to the Commissions with remarkably few guidelines. I suspect that most staff would like to get the final regulations published, take some vacation, and "hunker down" back in their familiar territory. That would squander an unprecedented opportunity for further dialogue and the development of mutual approaches to common supervisory issues.

It should be evident to all that despite the occasional rhetorical flourish to the contrary, Congress is not going to modify its internal distribution of power and prestige in a manner sufficient to create a unified regulatory environment for US financial intermediaries. While the President's Working Group on the Financial Markets has brought an environment of cooperation among the financial regulators, what is needed today is a set of proactive joint initiatives. Areas for attention include: transparent financial reporting, regulatory capital requirements, supervision of internal controls, oversight of customer protection regimes, facilitation of enhanced market structures, prudent risk-based systems for handling collateral requirements and the extension of credit, continued access to cross-border investment opportunities, and the oversight of clearing arrangements. None of our financial regulatory agencies has a monopoly on good ideas or talented staff. Working closely and collaboratively is in the best interest of all market participants and the public at large.

- **A "Zero Based" Examination of Customer Protection Mechanisms:** The keystone of a transition to a "core principles" based approach to the regulation of intermediaries should be a "zero based" examination of the customer protection regime in place in the industry. Is "customer segregation", "SIPC insurance" or something else the optimal means to protect customers from the insolvency of an intermediary? Previous examinations of this issue have not been "zero based." Instead, they have been surrounded by a near religious zealousy on the part of exchanges convinced *a priori* that any change would necessarily impose greater transactions charges on their floor based members and smaller intermediaries. I would suggest an examination of the following issues:
  - What do customers want?
  - Does the existence of distinct customer protection regimes unnecessarily limit cross-market investment strategies?
  - Does the lack of clearly specified priorities and instructions to the trustees of the estate of a dual registrant unfairly jeopardize customers or pose material systemic risk?
  - Could a uniform "client money" rule, jointly administered by the CFTC and the SEC, work as well in the US as it seems to in the United Kingdom?
  - Can SIPC coverage be extended to futures accounts without the imposition of a burdensome transaction charge?
  - To what extent will the potential success of security futures, and the growing number of "cross-margin" systems, dilute the distinctions between the two customer protection regimes?

Even if a finding is made that the current customer segregation customer protection regime has the greatest utility for US futures markets, certain important modifications need to be made. In particular, the current treatment of customer funds held outside the United States and/or denominated in a currency other than US dollars is unnecessarily confusing and administratively burdensome. A far more optimal result could be obtained by amending the Part 190 rules and associated appendices to establish specific distribution procedures and priorities in the event of the insolvency of an FCM holding customer funds offshore.

- **Clearing Arrangements**: The recent reorganization of the Commission's Divisions undertaken by Chairman Newsome demonstrates a keen understanding of clearing issues. The oversight of clearing organizations and the oversight of intermediaries is inextricably linked, and fundamentally distinct from the oversight of markets. In that context, I would encourage the Commission to charge the very talented new Director of the Division of Clearing and Intermediary Oversight and her staff to undertake an examination of the impact of derivatives clearing organizations on market structure and competition.

  I have argued elsewhere[3] that clearing organizations have many of the elements Richard Posner attributes to natural monopolies. As such, the "Doctrine of Essential Facilities," first described in a 1912 case "United States v. Terminal Railroad Association {224 U.S. 383}" and elaborated upon in the case involving MCI and AT&T [708 F. 2d 1081, 1132 (7th Cir. 1983)], may be relevant in evaluating the public policy implications of the behavior of clearing organizations in certain circumstances. This doctrine, in essence, holds that a monopoly owner of a key input cannot deny access if an entity seeking access cannot practically obtain the input elsewhere. Open interest in listed derivatives contracts, the pool of collateral and the claims on capital supporting that open interest could be deemed to be "key inputs". The vertical integration of those "key inputs" with the facilities of a specific market could be deemed a denial of access. It may be that the antitrust immunity granted in contract market status designation by the Commission appropriately recognizes the public policy implications of this apparent natural monopoly. Alternatively, particularly in the instance of a futures contract on an index exclusively provided by a 3rd party vendor, these clearing arrangements may unfairly limit investors' ability to obtain the benefits of competing market centers.

- **Portfolio Margining:** The application of portfolio margining concepts to the collateral and credit relationships between an intermediary and its customers of all types is an area where the US futures industry, under the oversight of the CFTC, has set the standard. The securities industry, led by a committee of the Securities

[3] "Are Clearing Organizations Natural Monopolies? Implications for Market Structure," unpublished paper presented at the Georgetown University McDonough School of Business Capital Markets Research Center's Seventh International Forum on "Evolving Structures of Securities Markets," May 2, 2002.

Industry Association with the active participation of The Options Clearing Corporation, the New York Stock Exchange and the options exchanges, is currently undertaking a rigorous examination of the merits of extending portfolio margining beyond the currently limited population of market professionals. While there are many legitimate differences between the concept of margin in a securities account and in a futures account, and material differences in the scope, diversity, concentration and economic function of futures and securities markets, it is nonetheless the case that the Commission can and should provide valuable insight gained from the oversight of the operation of complex portfolio margining systems.

- **Cross-Border Investing:** The Commission needs to continue to provide leadership in reducing the barriers to cross-border investing, both into and out of the U.S. One important area that needs additional focus is that of foreign stock index futures. While 42 such contracts have been "grandfathered," there still exist contracts that are currently offered by exchanges, but which had not obtained a "no-action letter" prior to the passage of the CFMA. To the extent that these contracts have the same characteristics as the existing 42, they should be afforded similar "no-action" status.

The financial services industry in the United States is going through a very traumatic period. Investor confidence in our markets has been shaken. Profit pressures on intermediaries are intense. Consolidation continues. The pace of innovation is intensifying. Among the strengths of the US capital markets is the willingness of all types of participants: customers, intermediaries, markets and regulators to "re-invent" themselves. This willingness must continue, in good times and in bad, if our competitive advantage is to persist. I appreciate the opportunity you have afforded to provide input into a potential renovation of the regulation of intermediaries in the futures industry.