Joint CFTC-SEC Hearings on Regulatory Harmonization

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Chairman Schapiro, Chairman Gensler, Commissioners and Staff, thank you for inviting me today to testify today on the harmonization of market regulation between the CFTC and the SEC. I am pleased to be here to offer my thoughts on how the agencies can effectively work together to regulate financial markets that offer similar products traded by many of the same participants, yet still present significant differences that make identical regulation impractical. I am a partner at Sullivan & Cromwell LLP. We represent a number of participants in the markets regulated by the CFTC and the SEC. However, the views I am presenting today are my own.

As many of you know, I had the honor to work in the Federal Government in the 1970s and 1980s and to serve as General Counsel of the CFTC under Chairman Susan Phillips and alongside now Chairman Schapiro. Collaborating with Gary Lynch, then the SEC Director of Enforcement, we signed the first international enforcement Memorandum of Understanding with the UK Treasury. In my many years of working in this industry, I know that successful harmonization depends on personal rapport. In that regard, I am pleased to see the two agencies being led by such capable individuals dedicated to effective regulation and market integrity. I do have a few thoughts on harmonization I would like to share.

I support the efforts of the agencies, and of Congress, to promote harmonization of the regulatory schemes administered by the CFTC and the SEC. As the reform of the regulatory structure progresses, it is essential that participants in the important financial markets overseen by the agencies be subject to a consistent scheme of regulation that promotes common principles and goals. Clearly, it is in the interests of the regulators as well as the markets to develop harmonized systems of regulation.

<u>Role of Primary Regulator</u>
Chairman Gensler's recent letter to Congressional leaders can be instructive on this issue, and provide a road map for harmonization of the regulatory structure along the lines that I outline below. As Chairman Gensler pointed out, legislation passed by Congress should avoid duplicative regulation and establish a "primary" regulator that has jurisdiction over specific products, markets, and market

participants. Although his statement was in reference to mixed swaps, I believe it can be applied more broadly. As he noted, "Dual regulation… suggests that both agencies will be regulating the same activities, which may yield duplication and inefficiency." Instead of requiring both agencies to regulate "mixed swaps," which are swaps that derive their value from both a security and a non-security, such as an interest rate or currency, he urged Congress to designate one regulator, based on whether the swap is "primarily" security-based or if it is "primarily" anything else.

I believe this principle of a "primary" regulator should apply more broadly to regulations, enforcement and oversight for the security and commodity markets. There should be a primary regulator for a given product and market; the other regulator should be consulted where necessary or appropriate, but should generally defer to the primary regulator. The primary regulator should be responsible for enforcement, audit and oversight of products and markets for which it is the primary regulator. This approach will reduce legal uncertainty and effectively speed needed products to market. Given that the current legislative proposal from the Treasury Department gives both agencies expansive rule-making authority to define market products and participants, both agencies can craft rules that follow the "primary" regulator principle.

We have many examples of inefficiencies created by not following the "primary" regulator model. Following the implosion of Amaranth, both the CFTC and the Federal Energy Regulatory Commission brought charges against the Fund – the CFTC charged Amaranth with attempted manipulation, arguing that Amaranth unsuccessfully tried to lower natural gas prices by selling large numbers of natural gas futures contracts. The very next day, the FERC charged Amaranth with successfully manipulating the natural gas market, for the very same activity that the CFTC argued did not constitute market manipulation. Although Amaranth's alleged misconduct occurred in the futures market, FERC contended that it had jurisdiction because the activity was intended to, and did, affect the markets for physical commodities regulated by FERC. Conversely, the CFTC takes the position that it has the jurisdiction to prosecute manipulation or attempted manipulation occurring in the physical market because of the possible effect on the futures markets. The jurisdictional lines between the two agencies remain unresolved and unclear.

Moreover, the two agencies, like the CFTC and the SEC, have different standards with respect to manipulation and different conduct that they expect of their regulated entities. This type of overlapping and uncertain jurisdictional situation can serve only to confuse market participants, create gaps in regulation and undermine effective regulation. The SEC and the CFTC should make clear which agency has jurisdiction over which businesses, products and activities, and the manner in which market participants will be regulated. Ultimately, duplicative regulation and overlapping regulatory jurisdiction will require market participants to comply with multiple registrations, financial and reporting requirements and will result in regulators examining substantially similar information – leaving both agencies spread thin, but without allowing either agency to focus more deeply on market issues related to their particular jurisdiction.

Such a "primary" regulator system would greatly enhance regulatory harmonization between the agencies, and would eliminate legal uncertainty that can lead to market disruption and volatility. By coordinating between a primary regulator and a secondary regulator, the agencies will reduce the risk of overlapping and inefficient oversight and can focus on ensuring market stability and transparency through proper regulation of markets, their products and market participants. I urge both the CFTC and the SEC to carefully consider the idea of a primary regulator as they move forward with regulatory harmonization.

<u>Harmonization of Regulation Does Not Require Identical Regulation</u>

I believe that harmonization does not mean identical regulation. Harmonization, in my view, means that different regulatory regimes, reflecting the important differences between the markets and products they regulate, are based on consistent principles that are adapted to the needs and circumstances of each market.

As one example, the Federal Trade Commission recently adopted an anti-manipulation rule for the wholesale crude oil market that was modeled on SEC Rule 10b-5. In fact, the FTC was required by Congress to adopt a rule based on Rule 10b-5. However, while the FTC used the same principles that guided the SEC in crafting this rule, and stated that precedents under Rule 10b-5 would be looked to for guidance in applying and interpreting the FTC Rule, the FTC also made modifications to the Rule to make it work better in the context of the crude oil market. Among other things, the FTC limited the extent to which market participants might be held liable for material omissions, due to the fact that there typically are no affirmative disclosure obligations in the crude oil markets. These rules are therefore harmonized, but clearly are not identical.

As the CFTC and SEC move forward with new regulations, I urge you to take into account the differences between markets and products to craft regulations that work in the context of the specific market. As another example, the administration has proposed that swap dealers be subject to capital and margin requirements regardless of whether they are regulated by the CFTC, the SEC or the banking regulators. However, these requirements should be tailored to the nature of the markets in which these dealers operate and the products they offer and should apply consistently to all participants in the relevant market. The level of capital required to be maintained by dealers, and the type and amount of margin they obtain from their counterparties, should be based on the criteria developed by the relevant regulator to protect against systemic risk and dealer defaults that can cause disruption in specific markets and to counterparties operating in these markets. These criteria must be developed in reference to the needs and objectives of the specific markets they are designed to protect, to take into account relevant factors such as market liquidity, relationship to the relevant cash market, the number and type of participants in the relevant market, and the volatility of the underlying assets.

Harmonization should ensure that regulations are properly developed and implemented to account for the differences between market participants in various markets. While the securities markets have many smaller, retail customers, commodity market participants tend to be larger, more sophisticated, institutional or commercial participants. Therefore, regulations designed to protect retail customers should allow greater flexibility for more sophisticated and better-capitalized end-users. The same applies to customer protection regimes which can and should take into account the sophistication of the customer.

This is also true for the regulation of exchanges, Alternative Swap Execution Facilities and clearing houses. Harmonization can be achieved by ensuring that the regulatory schemes are designed to accomplish the same objectives, but the precise regulatory requirements that are applicable to exchanges, Alternative Swap Execution Facilities and clearing houses for security-based swaps can differ based on the underlying product and the persons with access to the relevant market.

The Example of "Insider Trading"

Although my arguments for regulatory harmonization are forward-looking, there is significant historical precedent for regulatory harmonization that recognizes the differences between futures markets and the securities market. In 1982, as part of the reauthorization of the Commodity Futures Trading Commission, Congress, noting the regulatory disparities between the CFTC and the SEC, requested that the CFTC report on the nature, extent and effects of insider trading in the futures markets.[1] Although the SEC had in place prohibitions against insider trading, the

[1] A Study of the Nature, Extent, and Effects of Futures Trading By Persons Possessing Material, Non-Public Information, Submitted to the Committee on Agriculture of the House of

CFTC had not put in place such prohibitions. At the very outset of the report, the CFTC noted that "certain traditional notions concerning the legal requirements for establishing insider trading under the securities laws are of limited applicability, if any, to the futures markets."[2] For example, a securities "insider" is deemed to owe a fiduciary duty to the issuer of the security and its shareholders; transactions in the futures markets do not create a similar fiduciary duty.[3] In addition, the report noted that information that affects futures markets is generally not firm-specific, which is normally the case with regard to securities markets.

The report ultimately noted that in general, the functions of the futures markets, the types of information pertinent to them, and the various groups of people who might possess relevant information in the futures markets are very different than those in the securities markets, as "… futures contracts are different instruments from securities and futures markets evolved for reasons different from those for which trading in securities developed."[4] Therefore, the justification for the prohibitions against insider trading in the securities markets had little or no relevance to the futures markets.[5] Furthermore, "[T]he term insider trading can be misleading if it is assumed to carry with it the same kinds of relationships in the futures markets as in the securities markets."[6]

As a result of the fundamental differences in the futures markets and the securities markets, regulations against insider trading in the futures markets evolved differently than the analogous regulations in the securities markets. Currently, there are only a few prohibitions against "insider trading" as understood in the securities context, mainly because being "insider" is not applicable to futures instruments, such as commodities. Yet, there is the concept of misuse of information in the futures market as well. For example, a futures broker can be charged with fraud if he or she receives a significant order from a client that is likely to affect the price of that commodity, and then makes proprietary trades on

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Representatives and the Committee on Agriculture, Nutrition, and Forestry of the Senate, Commodity Futures Trading Commission, September 1984.

[2] P. 6

[3] Pp. 6-7

[4] P. 17, Appendix IV-A

[5] P. 17, Appendix IV-A

[6] P. 7

that order before executing the client's order in order to benefit from the anticipated price change.

The creation of different, yet complementary, regulations to address the misuse of information in the futures markets and the securities markets demonstrates the effectiveness of regulatory harmonization. I urge both agencies to continue to use such principles, as you draft regulations that recognize the similarities in and differences between the futures market and the securities markets.

Harmonization Should Promote Competition and Prevent Regulatory Arbitrage

In addition, harmonization should look at the differences in regulation and market structure and encourage the best ideas of either agency that can promote competition and innovation. Where the markets are structured similarly, successful ideas of one regulator and industry should be carefully examined to determine if they can be beneficial in the other. 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. Other ideas, including the new product approval process on the futures side, also are worthy of consideration in the securities environment. The existence of two regulators with comparable but not identical missions should be an opportunity for harmonizing in such a way as to pick the best ideas of each to the benefit of the other and the market as a whole.

In addition, harmonization is essential to prevent regulatory arbitrage, that is, allowing market participants to structure transactions in such a way to evade stricter or more burdensome regulation, both between the CFTC and the SEC, as well as between U.S. regulators and foreign jurisdictions. We must coordinate any regulatory efforts with those in Europe and elsewhere around the world to ensure that more comprehensive regulations in the United States do not result in the migration of business overseas. This would be a troubling development, as liquidity leaves U.S. markets and flows to markets with less onerous regulations. Regulatory harmonization between U.S. regulators and foreign regulators is crucial, and I urge the CFTC and the SEC to work in coordination with your foreign counterparts.

I want to thank the CFTC and the SEC, as well as Chairman Gensler and Chairman Schapiro for affording me the opportunity to share my thoughts on regulatory harmonization and I look forward to continuing this dialogue.