SIFMA

Securities Industry and Financial Markets Association

September 14, 2009

Via email to: **rule-comments@sec.gov; secretary@cftc.gov**

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David A. Stawick
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Re: SEC Release No. 34-60539; File No. 4-588
CFTC "Harmonization of Regulation"
Re: Harmonization of SEC and CFTC Regulation

Dear Ms. Murphy and Mr. Stawick:

The Securities Industry and Financial Markets Association ("SIFMA")[1] thanks the Securities and Exchange Commission (the "SEC") and the Commodity Futures Trading Commission (the "CFTC") (collectively, the "Agencies") for the

[1] The Securities Industry and Financial Markets Association brings together the shared interests of more than 600 securities firms, banks and asset managers. SIFMA's mission is to promote policies and practices that work to expand and perfect markets, foster the development of new products and services and create efficiencies for member firms, while preserving and enhancing the public's trust and confidence in the markets and the industry. SIFMA works to represent its members' interests locally and globally. It has offices in New York, Washington D.C. and London and its associated firm, the Asia Securities Industry and Financial Markets Association, is based in Hong Kong.

opportunity to comment on the harmonization of the rules of the Agencies. This issue affects many SIFMA members, including 54 of SIFMA's largest members, that are registered both as broker-dealers and futures commission merchants ("FCMs").

SIFMA strongly supports the effort to harmonize the rules governing securities and futures markets and their participants. As CFTC Chairman Gary Gensler noted in his comments at the joint hearings of the Agencies (the "Hearings"), harmonization would benefit the American public in three ways: by eliminating gaps in the financial regulatory system; by ensuring that any overlaps between CFTC and SEC regulation help markets rather than provide an opportunity for regulatory arbitrage or uncertainty; and by ensuring that similar products are treated similarly by all regulatory regimes. Such efforts are essential not only because of the increasing number of new products sharing characteristics of both futures contracts and securities, but also because the Administration's proposed legislation would replicate the existing jurisdictional divisions in extending regulation to over-the-counter derivatives. In assessing the means and likelihood of success of achieving regulatory harmonization, it is prudent to remember the differing philosophies that underlie the regulation of the securities and futures markets.

As a procedural course, SIFMA urges the Agencies to use the opportunity of the September 30, 2009 deadline suggested by the Department of Treasury in its June 17, 2009 White Paper on Financial Regulatory Reform (the "White Paper") to issue an interim report identifying the specific areas of regulation on which the Agencies intend to focus their harmonization efforts and request detailed comments on those areas. On that basis, this letter will identify and discuss in general terms those areas that SIFMA believes should be harmonized on a priority basis, and SIFMA will submit detailed comments and recommendations on these specific areas as part of futures discussions. Moreover, while SIFMA has advocated in the past for the merger of the Agencies and still holds the view that such a merger would be optimal, in light of the White Paper's recommendations and the particular call for comments to which this letter responds, we restrict our discussion to harmonization of the rules of the Agencies as separate entities.

Different Philosophies, Different Rules

Underlying the regulatory regimes governing securities and futures markets and market participants are fundamental differences in how Congress and, therefore, the Agencies, have historically understood these markets. The regulation of futures exchanges developed in the United States, starting with the Grain Futures Act of 1922 and, soon after, the Commodity Exchange Act of 1936 (the "CEA"), to provide oversight of markets populated by knowledgeable professionals trading in commodities they understood well. The CFTC, established through the Commodity Futures Trading Commission Act of 1974, thus developed a regulatory structure meant to protect users by ensuring the integrity of the marketplace through tools such as large trader reporting rather than focusing on retail investor protection issues. As former CFTC Acting Chairman Walter Lukken has noted, "The CFTC's primary mission under the Commodity Exchange Act is to ensure that the commodity futures and options markets operate in an open and competitive manner, free of price distortions. The CFTC fulfills this obligation through a comprehensive, multi-faceted program that is designed to identify and mitigate the potential for manipulation and other market abuses, and to ferret out and punish illegal behavior."[2] Acting Chairman Lukken has further noted that "the relative lack of retail participation in [futures] markets allowed the Commission to address these global policy matters without the added customer protection complexities."[3]

The securities markets, on the other hand, historically center on the capital raising activities of corporations and other companies. The SEC was established by Congress in 1934 in response to perceived abuses by issuers and market professionals whose illegal activities undermined the willingness of both individuals and institutions to entrust their savings to the capital markets. As a result, the SEC's primary mandate has long been investor protection. In the SEC's own words, "Congress established the Securities and Exchange Commission in 1934 to enforce the newly-passed securities laws, to promote stability in the markets and, most importantly, to protect investors."[4] Thus, "[t]he laws and rules that govern the securities industry in the United States derive from a simple and straightforward concept: all investors, whether large institutions or private individuals, should have access to certain basic facts about an investment prior to buying it, and so long as they hold it."[5] This focus is evident from the array of investor protection rules, such as suitability and other sales practice requirements that have no analogues in futures market regulation.[6] In addition, the fact that debt and equity securities are often issued by, and require an

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[2] *See* Walt Lukken, Statement at FERC Compliance Summit, Jan. 18, 2008, *available at* http://www.cftc.gov/stellent/groups/public/@newsroom/documents/speechandtestimony/opalukken-34.pdf.

[3] *See* Walter Lukken, *It's a Matter of Principles*, University of Houston's Global Energy Management Institute, Jan. 25, 2007, *available at* http://www.cftc.gov/newsroom/speechestestimony/opalukken-23.html.

[4] *See* Securities and Exchange Commission, *The Investor's Advocate: How the SEC Protects Investors, Maintains Market Integrity, and Facilitates Capital Formation*, *available at* http://www.sec.gov/about/whatwedo.shtml.

[5] *Id*.

[6] See *infra*. In some sales practice rules, such as FINRA's suitability rule, institutional investors have been excepted based on their investment acumen and access to market information. *See* FINRA IM-2310-3.

assessment of, the current and prospective financial condition and performance of operating companies, whereas commodity futures contracts are not, means that many SEC rules, but not CFTC rules, focus on the material completeness and accuracy of disclosure and the fair access of all market participants to such disclosure.

In recent years, however, the differences between the futures and securities markets have narrowed. Securities markets have become dominated by institutional, professional investors as individuals increasingly invest through retirement plans, insurance companies and investment companies. Conversely, futures markets have become more accessible to individual investors through mini-futures contracts and other financial products that share certain elements of futurity. Many market participants, including many SIFMA members, actively trade across asset classes including both securities and futures, as well as derivatives contracts that share aspects of each. In addition to the shifting nature of the market participants, there has been a proliferation of new products that do not fit neatly into the formerly distinct categories of securities and futures. Some of these products straddle the line between futures and securities, while others are structured as a security or future but are economically similar to products historically found in the other class. As the White Paper notes, "While differences exist between securities and futures markets, many differences in regulation between the markets may no longer be justified. In particular, the growth of derivatives markets and the introduction of new derivative instruments have highlighted the need for addressing gaps and inconsistencies in the regulation of these products by the CFTC and SEC."[7]

Although real differences continue to exist between the nature of futures and securities products and their markets, these differences do not fully justify the continuing disparities in regulation of these markets, nor the regulatory "no-man's land" for instruments that do not fall exclusively in the categories of futures or securities. Until Congress acts to reconcile the statutory regimes that govern futures and securities, the Agencies need to work cooperatively to harmonize their rules wherever possible and to adopt procedures to facilitate the creation of new products.

Principles-Based vs. Rules-Based Regulation

The difference in mandate described above has manifested itself in different philosophies towards rulemaking. The Commodity Futures Modernization Act of 2000 applied a "principles-based approach" to supervision of futures contract markets, derivatives transaction execution facilities and

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[7] DEPARTMENT OF THE TREASURY, FINANCIAL REGULATORY REFORM – A NEW FOUNDATION: REBUILDING FINANCIAL SUPERVISION AND REGULATION 7.

derivatives clearing organizations. These entities are subject to "core principles" that provide the framework governing their activities, providing the entities with a range of latitude in conducting their business.[8]

In contrast, the laws governing the securities markets, including the Securities Act of 1933 (the "Securities Act") and the Securities Exchange Act of 1934 (the "Exchange Act"), apply a "rules-based approach" under which the SEC is directed or authorized to adopt rules governing securities market participants, and securities exchanges and clearing agencies must submit their rules for prior approval by the SEC. The SEC has adopted detailed rules to provide specific guidance as to how market participants need to comply with the securities laws.[9] These rules are normally developed through a lengthy process that includes formal rule proposals and opportunities for public comment. The SEC can enforce adopted rules with the full panoply of enforcement authorities provided to it under the securities laws.

The distinction between the principles-based approach of the CFTC and the rules-based approach of the SEC was highlighted in the Hearings and in the White Paper, which specifically recommends that the Agencies develop "a common foundation for market regulation through agreement … on principles of regulation that are significantly more precise than the CEA's current 'core principles.'"[10] SIFMA believes that the Agencies should find a middle ground under which core principles guide the more rapid implementation of exchange trading rules and new product approvals, with more deliberate review of self regulatory organization ("SRO") rule filings that govern member conduct or disciplinary matters, as discussed below.

[8] For example, one of the core principles incumbent upon boards of trade designated as contract markets is that, "The board of trade shall list on the contract market only contracts that are not readily susceptible to manipulation." 7 USC § 7(d)(3). Section 5c(a) of the CEA allows the CFTC to provide interpretations of these core principles, although the CEA explicitly states that such interpretations "shall not provide the exclusive means for complying" with the core principles. The CEA further provides that "[i]f the Commission determines, on the basis of substantial evidence, that a registered entity is violating any applicable core principle … the Commission shall (A) notify the registered entity in writing of the determination; and (B) afford the registered entity an opportunity to make appropriate changes to bring the registered entity into compliance with the core principles." 7 USC § 7a-2(d). The CFTC has authority to pursue further actions only after 30 days have elapsed without appropriate action by the offending entity.

[9] For example, Rule 15c3-1 under the Exchange Act is a complex rule that sets out specific net capital requirements for broker-dealers and other market participants, which vary depending on the activities of the market participant.

[10] DEPARTMENT OF THE TREASURY, s*upra* note 7, at 50.

Market Structure and Fungibility

As discussed by several participants in the Hearings, the securities and futures exchanges differ dramatically in their market structure. In particular, identical securities are traded on multiple U.S. markets as part of the "national market system" developed in response to the passage of the Securities Act Amendments in 1975 (the "1975 Amendments"). While originally each 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 these so-called "fungible" 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. This structure differs dramatically from the futures markets. Unlike securities, which are traded on a number of exchanges, individual futures contracts are generally traded on one particular exchange. An exchange with the dominant trading of a futures instrument also handles the clearing of that instrument. In the futures markets, competition exists among U.S. 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.

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. As a result of 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. The competition between securities trading centers, which benefits market participants through lower cost and increased innovation, is largely absent from the futures market. In addition, the existence of a common clearer helps reduce systemic risk through enabling offsetting positions, a benefit not available in futures markets.

SIFMA believes that the Agencies should encourage more vigorous competition between markets trading similar products. An important component of the structure to encourage competition is a linked and coordinated clearing system for a product, available to all participants in the market. As the Department of Justice noted in a comment letter to the Treasury Department, "If greater head-to-head competition for the exchange of futures contracts could develop, we would expect it to result in greater innovation in exchange systems, lower trading feeds, reduced tick size, and tighter spreads, leading to increased trading volume."[11]

[11] Letter from the U.S. Department of Justice to the Department of the Treasury, Review of the Regulatory Structure Associated With Financial Institutions (Jan. 31, 2008).

The creation of a linked and coordinated clearing system that allows positions in one clearer to be offset by positions in another is of particular importance in light of the Treasury's proposed legislation requiring mandatory clearing of standardized over-the-counter ("OTC") derivatives contracts. One of the key elements to successful competition in clearing OTC derivatives will be the ability to extend cross-margining across a wide range of positions. If futures or securities positions can only receive margining credit at one clearing organization, the clearing organization with the largest base of margin positions will have a nearly-insurmountable advantage in clearing OTC derivatives products.

Portfolio Margining

The securities laws and the CEA diverge widely in how they seek to protect investors and financial intermediaries from excessive risk exposure to each other and the resolution of outstanding claims in bankruptcy. The CFTC and the SEC have made significant progress in recent years in this regard, including the SEC's approval of amendments to New York Stock Exchange ("NYSE") and Chicago Board Options Exchange ("CBOE") rules in 2006 to expand the scope of products eligible for portfolio margining to include equities, equity options, broad based index futures, security futures products and unlisted derivatives and provide for cross-margining for larger accounts.[12] However, a number of differences remain between the CFTC and SEC's regimes that prevent investors from achieving the full benefits of portfolio margining from being attained, including impediments to offsetting positions across securities and futures holdings and uncertainty as to the resolution of the accounts of customers in the insolvency of a dually registered broker-dealer/FCM.

These issues arise from differences between the Agencies' customer protection regimes. Section 4d(a)(2) of the CEA requires that all funds and property (including securities held as collateral) in a customer's futures account generally must be segregated from other funds and properties. By contrast, securities customers' funds and securities are required to be segregated from the

[12] The risk-based portfolio margining methodology for products subject to the jurisdiction of the SEC involves "shocking" each portfolio at different valuation points along a range representing a potential maximum percentage increase or decrease in the value of an instrument or (in the case of a derivative instrument) its underlying stock or index. Theoretical gains or losses for each instrument in the portfolio at each calculation point are then netted, and the greatest loss in the portfolio at any calculation points is then determined. The approach allows for further offsetting between portfolios of the same type.

The futures markets, on the other hand, utilize a more model-driven risk-based system to determine futures margins. Offsetting of gains and losses at each test point is permitted to the extent losses and gains on other products held by a participant are determined to be historically correlated.

broker-dealer's funds and securities only when the securities are either not margined or their value exceeds the level that is needed for margin requirements. Broker-dealers are permitted to use the non-segregated customer assets for funding extensions of credit to their customers.[13] These customer protection requirements in turn derive from the insolvency regimes applicable to broker-dealers and FCMs. Securities customers are partially insured against a broker-dealer's failure through the Securities Investor Protection Corporation ("SIPC") fund, whereas futures participants are protected through the segregation of customer funds and portability of these funds to other FCMs in the case of insolvency. As a result, dual registrants maintain separate accounts for customers' futures and securities positions.

There are two prominently cited approaches for resolving these differences and allowing for the use of comprehensive portfolio margining across securities and futures positions. One option, known as the "two pot" model, is to allow a dual registrant to maintain separate securities and futures accounts, but to make a risk-based calculation that takes into account positions in both accounts. Another option is the "one pot" model in which all positions, including securities and futures, would be held in a single portfolio margining account, subject to one consistent margin approach to be agreed upon between the Agencies.

SIFMA strongly believes that the preferred approach is a "one pot" model, consistent with the international standard of use of a single account for risk-based margin requirements. Holding the positions in one account would avoid the difficulty of having to segregate margin relating to futures positions from that relating to securities positions, a task that would be complicated by offsetting between futures and securities accounts, and would allow broker-dealers to continue to use the securities in the account to extend credit to customers. Customers should be provided the alternative, however, to continue to hold their futures positions in a separate segregated account if they prefer to maintain portability of their positions in the event of the intermediary's bankruptcy.

The "one pot" model would require modest changes to both the CFTC's and SEC's rules. The CFTC would need to provide an exemption from the futures segregation requirement to permit futures to be held in a non-segregation account with securities. SIPC coverage would need to be extended to futures and futures options held in a securities portfolio margin account. In addition, accounts of a broader range of securities market participants should be eligible for portfolio margining in a securities account. Finally, the SEC and CFTC would need to agree on one consistent portfolio margining method to be applied to these accounts. These changes should be accompanied by rigorous risk management at the clearinghouses, for example, through inter-clearinghouse agreements for offsetting positions.

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[13] Rule 15c3-3, Securities Exchange Act of 1934.

Product Certification and Approval

Jurisdictional disputes between the CFTC and the SEC can lead to unacceptable delays in new product review and regulatory approvals, which discourage innovation and move business offshore. A well-known example is the proposal by CBOE to list credit default options that was delayed seven months pending a jurisdictional dispute, during which time the product began to trade on Eurex. A proposed CBOE listing of options on the S&P 500 Dividend Index has led to disputes over whether such a product would be an option on a securities index or an event contract.[14] Other products that have been subject to jurisdictional dispute include derivatives based on securities based on commodities, such as options on gold exchange traded funds ("ETFs"). Such disputes will become more common and problematic if Treasury's proposed Over-the-Counter Derivatives Markets Act is enacted.

Generally, the process for approving trading of new futures products is more streamlined than that for approving trading of new securities. This stems, in large part, from the difference between the CFTC's principles-based regulation regime and the SEC's focus on detailed listing standards regarding new products. For example, the SEC must approve an exchange listing standard for a new product unless, under Rule 19b-4(e), there are already-approved SRO "trading rules, procedures, and listing standards for the product class that would include the new derivative securities product and the [SRO] has a surveillance program for the product class."[15] The CFTC allows for the introduction of products to the market upon a certification that the product does not violate the terms of the CEA. If it desires, however, the CFTC can further investigate the listing and clearing of any new product, and is most likely to do so where the product is new and innovative or characterized as a security rather than a futures contract.[16] SIFMA believes the SEC should move towards such a streamlined approach for securities-based products in order to encourage innovation in that sector.

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[14] *See* Securities Exchange Act Release No. 59667 (March 31, 2009), 74 FR 15528 (April 6, 2009), *available at* http://sec.gov/rules/sro/cboe/2009/34-59667.pdf; E-mail from Julian E. Hammar, Assistant General Counsel, CFTC, to James Eastman, Chief Counsel and Associate Director and Elizabeth King, Associate Director, Division of Trading and Markets, SEC (May 4, 2009), *available at* http://sec.gov/comments/sr-cboe-2009-022/cboe2009022-1.pdf; Letter from Jenny L. Klebes, Senior Attorney, Legal Division, CBOE, to Elizabeth M. Murphy, Secretary, SEC (May 19, 2009), *available at* http://sec.gov/comments/sr-cboe-2009-022/cboe2009022-2.pdf.

[15] Rule 19b-4(e), Securities Exchange Act of 1934.

[16] The delay in the CBOE's proposal to list credit default options, described above, is an example.

Further complicating the issue of new product approvals is the role of derivatives clearing organizations, such as the Options Clearing Corporation ("OCC"). In order to ensure that new products comply with the requirements of its regulators, the OCC must be sure of the proper classification of each new product it clears. While the OCC in concept can certify to the CFTC that a new product comports with the CEA, in practice the OCC needs the approval of a new product from the SEC and the CFTC, which is not necessary for clearing organizations dealing with pure securities or pure futures contracts. To encourage the development of new exchange-traded derivative products, clearing organizations need to be able to operate in a landscape of legal certainty.

The Agencies have recognized that coordination on new product approvals is crucial. On March 11, 2008, CFTC Acting Chairman Walter Lukken and SEC Chairman Christopher Cox entered into a Memorandum of Understanding (the "MOU") to, among other things, coordinate "[p]roposals to list or trade novel derivative products."[17] In particular, the SEC and CFTC designated a set of "Derivative Products Contacts" "[t]o facilitate the discussion and coordination of issues of regulatory interest,"[18] among the Director of Trading and Markets of the SEC, the Director of the Division of Market Oversight at the CFTC and two staff members chosen by each. However, the MOU has not resulted in a discernable improvement in the approval of new products touching jurisdictional lines of the Agencies.

SIFMA believes that the Agencies should continue to address the issue of new product approvals as part of their regulatory harmonization efforts. The SEC should modify its rule approval processes to expedite the approval of new products, such as by adopting the certification process used by the CFTC for new futures products. In order to avoid undue delay in bringing valuable new products to the marketplace, it is necessary for the Agencies to further develop a method to resolve jurisdictional disputes in a timely manner. One possibility could be the involvement of a neutral entity, such as the Obama Administration's proposed Financial Services Oversight Council, to facilitate resolution of the open issues blocking implementation of new products if, after prompt consideration by the Agencies, agreement on the treatment of these products has not been reached.

Regardless of the mechanism, however, harmonization that ensures the timely introduction of new products into the market is crucial. The U.S. financial markets have long been an incubator of financial innovation. Where the new products face the bifurcated regulatory structure of the Agencies, which has no

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[17] 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, Mar. 11, 2008, at 3, *available at* http://www.sec.gov/news/press/2008/2008-40_mou.pdf.

[18] *Id.* at 4.

parallel in other countries, U.S. markets often lose ground to offshore markets. While both Agencies provide valuable perspectives on the impact of new products on customers and the financial system that should be reflected in the supervision of the product, a process is needed to ensure these perspectives are taken into account without unnecessarily delaying financial innovation. SIFMA is concerned that ongoing delays will move financial innovation away from the U.S., with a consequent loss in jobs and adequate regulatory oversight of the financial industry, particularly if the OTC derivatives market becomes subject to the same dysfunctional bifurcated structure as prevails today.

Rule Certification and Approval

The Agencies' differing regulatory philosophies are reflected in the way they oversee rulemaking by the SROs that operate in their spheres. These SROs include market participant associations, such as the Financial Industry Regulatory Authority ("FINRA") for securities broker-dealers and the National Futures Association ("NFA") for FCMs and introducing brokers; exchanges, such as the NYSE, CBOE and the Chicago Mercantile Exchange; and other organizations engaged in securities- and futures-related activities, such as the Chicago Mercantile Exchange Clearing Corporation, the Depository Trust Company and the OCC.

All rules proposed by securities SROs must undergo an intensive approval process at the SEC, which may be preceded by a notice and comment process at the SRO itself. Under Section 19 of the Exchange Act, SROs must file with the SEC all proposed changes to existing rules, along with a "concise general statement of the basis and purpose of such proposed rule change."[19] Typically, the proposed rule is published in the Federal Register for public comment. By law, the SEC has an initial window of 35 days to either approve the rule change or begin proceedings to more thoroughly explore whether the rule should be disapproved, but in practice the approval process takes months longer and can stretch into years for a particularly controversial filing. Certain classes of non-controversial rule filings are effective upon filing, subject to being considered under a full notice and comment period if deemed significant by the SEC. As a result of these processes, the SEC's role in reviewing and approving SRO rules can result in delays in implementing changes to exchange and clearing agency rules.

The relationship between the CFTC and the futures SROs is different. In order to change a rule, the contract markets and derivatives clearing organizations need only provide the CFTC with a certification that the rule changes comport with the CEA. There is no standard notice for contract market SRO rule changes;

[19] Rule 19b-1, Securities Exchange Act of 1934.

such rules become effective unless the CFTC objects. The CFTC can investigate further any rule. As William Brodsky, Chairman and CEO of CBOE notes, “This structure enables SROs to implement business decisions promptly, yet permits the CFTC to concentrate on proposals that present significant regulatory issues.”[20]

As discussed previously, SIFMA believes that the process for listing new products on exchanges should be expedited for futures and securities products, as well as products with characteristics of both futures and securities. With respect to SRO rules governing the conduct of their members, however, SIFMA believes that both Agencies should provide a notice and comment period and should actively approve or disapprove these rules, much in the way the SEC does now. SRO rules have a very significant impact on the conduct of business by their members, governing a wide spectrum of broker-dealer and FCM activities, and subjecting broker-dealers and FCMs to disciplinary actions for noncompliance with these rules. Moreover, the activities of SROs increasingly overlap and at times compete with the activities of their members. Given the authority provided to SROs over their members and the significance of their rules for members' businesses, it is important that the Agency overseeing each SRO provide for notice and comment on significant rules governing the conduct of business and discipline of their members, and that the Agencies take an active role in the approval of these SRO rules before they become effective.

Sales Practices

SIFMA believes that disparate sales practice rules should no longer apply to broker-dealers and FCMs. For example, similar customer protection rules should apply to sale of a call option on gold ETFs and an option on gold futures.

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[20] *See* Testimony of William Brodsky, Chairman and CEO of the Chicago Board Options Exchange, Joint Public Meeting of the CFTC and SEC on Harmonization of Futures and Securities Regulation, Sep. 2, 2009, at 5, available at http://cftc.gov/stellent/groups/public/@newsroom/documents/file/jointmeeting090209_brodsky.pdf. Different requirements apply to CFTC approval of changes to the rules of registered futures associations, such as the NFA. Under Section 17(j) of the CEA, these associations must submit to the CFTC any new rules or changes to current rules. The association can request review of the rule or rule change from the CFTC or can make the rule effective ten days after receipt of the submission unless the CFTC decides on its own to review the rules. The CFTC has 180 days from receipt of the submission, unless a longer time is agreed to, to begin a hearing to disapprove the rule or rule change and one year from receipt of the submission to complete the hearing. If the CFTC does not meet this timing requirement, the rule or rule change becomes effective until a final determination is made. For registered securities associations, such as FINRA, the rule approval process is the same as for securities exchanges and clearing agencies.

Under the antifraud provisions of the securities laws and securities SRO rules, broker-dealers are subject to a "suitability requirement" that imposes a duty to recommend only securities that are suitable for the needs and financial condition of the particular customer. FINRA rules specify that a broker-dealer must have "reasonable grounds" for deciding its recommendation is suitable, and when dealing with a non-institutional customer, the broker-dealer must make reasonable efforts to obtain information concerning the customer's financial status, tax status, investment objectives and any other information that would be reasonably considered in this regard and then to use this information in making its suitability determination.[21] The standards for investments in options are heightened and require that the broker-dealer making the recommendation consider the knowledge and experience of the customer and the customer's ability to bear the risks of options trading.[22]

By contrast, neither the courts nor the CFTC have found that a product-oriented suitability requirement governs the customer relationship with FCMs. Indeed, the CFTC explicitly declined to adopt a proposed suitability rule because it "was unable at [that] time to formulate meaningful standards of universal application."[23] Instead, the CFTC adopted a rule requiring that FCMs provide to any new customer disclosure of the risks inherent in trading futures and receive a signed acknowledgement from the customer that the risks are understood. The NFA further has adopted a business-conduct standard, the "know your customer rule," which as interpreted requires an FCM to determine whether futures trading generally is appropriate for the customer.[24]

SIFMA believes that in reviewing these rules, the Agencies should harmonize them unless a compelling reason is found to do otherwise. SIFMA suggests that one means of doing so is to determine the appropriate standard for less sophisticated customers, perhaps including a simple risk disclosure document for all derivatives products and requiring a broker-dealer and FCM assessment of knowledge, experience and ability to bear the risks of trading in the instrument combined with a requirement that the recommendation not be unsuitable for the customer. This standard could be accompanied by an exception for institutional customers that have the capacity to evaluate investment risk independently, and who exercise independent judgment in evaluating recommendations, as in

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[21] FINRA Rule 2310.

[22] FINRA Rule 2360(b)(19).

[23] Adoption of Customer Protection Laws, 43 Fed. Reg. 31,886, 31,888 (July 24, 1978).

[24] NFA Interpretive Notice, NFA Compliance Rule 2-30: Customer Information and Risk Disclosure (June 1, 1986), *available at* http://www.nfa.futures.org/nfamanual/NFAManual.aspx?RuleID=RULE%202-30&Section=4.

FINRA's existing institutional suitability interpretation.[25] The SEC and CFTC should also harmonize their definitions of sophisticated institutions and reduce the number of institutional investor classifications to two or three key levels.

Mutual Recognition

A number of participants at the Hearings noted the different rules governing access by foreign markets and market intermediaries to U.S. broker-dealers, FCMs and customers. In general, the CFTC has been more willing to allow foreign exchanges to provide U.S. FCMs with direct access to their markets, and to allow foreign FCMs to deal with U.S. customers than has the SEC with respect to U.S. securities broker-dealers and investors. The CFTC allows U.S. FCMs to become members and route orders directly to foreign boards of trade that are from recognized countries; in contrast, the SEC requires that foreign exchanges register in the United States in order to accept members that are U.S. persons. Thus, while market participants can trade in futures on a foreign exchange from U.S. computer terminals, such trading is not allowed in equity or equity index options. As Peter Reitz of Eurex pointed out in his testimony at the Hearings, this leads to the incongruous result that 17% of the volume in the Dow Jones EURO STOXX® 50 Index futures contracts is traded by market participants from the U.S., while no trading can be done directly from the U.S. in the Dow Jones EURO STOXX® 50 equity options contracts. In addition, unregistered foreign FCMs are provided much greater ability to deal with U.S. customers than are their foreign securities broker-dealer counterparts.

These differing approaches to foreign markets and broker-dealers/FCMs has become increasingly problematic as trading has moved from floor-based systems to electronic, computer-based systems. With physical presence on the exchange no longer necessary, market participants increasingly seek to transact electronically across a number of markets, including global markets. The differences between the approaches of the CFTC and the SEC result in less immediate access by U.S. customers to global securities markets than global futures markets, for no discernable policy purpose.

SIFMA supports harmonization of the approaches of the CFTC and the SEC on access to foreign markets and intermediaries, and in particular the increased reliance on mutual recognition of exchanges and market participants in jurisdictions with comparable investor and market protection standards.

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[25] As indicated in our June 29, 2009 letter on FINRA Regulatory Notice 09-25, NASD IM 2310-3, SIFMA does not believe that institutions should be required to opt out of the suitability protection for the exception to apply. *See* SIFMA Comment Letter, http://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/noticecomments/p119333.pdf.

Accordingly, SIFMA encourages the SEC and CFTC to work together to extend the benefits achieved under the CFTC approach in order to provide the benefits of direct trading throughout the world to more U.S. market participants.

During the consideration by the Agencies of wider reliance on mutual recognition, SIFMA supports expanding the exemptions from SEC registration for foreign broker dealers available through Rule 15a-6 under the Exchange Act. Currently, foreign broker-dealers are exempt from SEC registration for dealings with large institutional investors subject to a range of conditions that create unnecessary costs and impediments to providing the services desired by these U.S. investors. SIFMA believes that the SEC should take prompt action to revise Rule 15a-6 to reduce the conditions imposed on foreign broker-dealers providing investment opportunities to U.S. institutional investors, even as it considers the mutual recognition approach. Thoughtful revisions of Rule 15a-6 are particularly appropriate as Congress prepares to consider proposed legislation requiring the registration of OTC derivatives dealers, with the attendant questions of the appropriate application of the registration requirements to foreign OTC derivatives dealers.

Net Capital Requirements

In many respects, the SEC's and CFTC's net capital rules are similar and provide jurisdictional certainty for dually registered broker-dealers. The CFTC has sought to cooperate with the SEC and increase consistency of net capital rules between the commodity futures industry and securities industry since as early as 1977 when it released a proposal for minimum financial requirements established by SROs.[26] Further progress towards harmonization came when the CFTC adopted rules that required FCMs that are also broker-dealers to maintain the amount of net capital required by the SEC, provided that it exceeded the CFTC's minimum.[27] Both Agencies also require notifications by the firms in the event net capital levels drop below a minimum amount.

Further harmonization of net capital rules should require coordination of the Agencies' changes to their net capital rules, given that dually registered entities must look to the net capital rules of both Agencies to determine which capital requirements are higher and to which they are therefore subject. For example, on May 8, 2009, the CFTC proposed to amend minimum adjusted net

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[26] Adoption of Amended Minimum Fin. Requirements, Comm. Fut. L. Rep. (CCH) ¶ 20,661 (Sept. 9, 1978).

[27] 14 Sec. Reg. & L. Rep (BNA) 1038 (June 4, 1982).

capital requirements for FCMs and introducing brokers.[28] A process of consultation and coordination on unilateral actions such as these would serve the Agencies well. This is important not only for ensuring a relative level of harmonization and certainty for firms that are dually registered, but also for providing opportunities for the Agencies to build upon their collective knowledge to develop the most appropriate rules.

Recordkeeping and Reporting

Recordkeeping and reporting rules imposed by the SEC and CFTC ensure a sound framework of records for business and supervisory purposes, which can be used to demonstrate compliance with net capital and customer protection standards, as well as prohibitions against manipulation, fraud and other market abuses. At the same time, disparate recordkeeping rules impose an unnecessary cost burden on dually registered firms.

The SEC and CFTC should jointly review their recordkeeping and reporting rules to require the same records and reports wherever possible. The SEC and CFTC should use this opportunity to identify and require the essential effective elements from both systems, and not simply aggregate the existing requirements. The rules should be simple and consistent across the securities industry and futures industry. This will reduce administrative costs and improve the effectiveness of the rules themselves. FINRA's initiative to review National Association of Securities Dealers and NYSE rules in creating a FINRA rulebook provides a model for the SEC and CFTC in this area.

It is also important that the SEC and CFTC strengthen their cooperation and coordination in the area of examinations. The securities rules already provide for some cooperation with the CFTC in this area. Specifically, the SEC must notify the CFTC of certain examinations it conducts and furnish, upon request, any related data. The SEC must also use any CFTC reports that are sufficient for the SEC's purposes prior to conducting its own examinations of registered brokers and dealers, registered exchanges and registered national securities associations.[29] The Agencies should expand their efforts to reduce the examination burden of dually registered broker-dealers and FCMs by coordinating their examination processes.

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[28] Release No. 5652-09, CFTC Seeks Public Comment on a Proposal to Amend Minimum Adjusted Net Capital Requirements of Futures Commission Merchants and Introducing Brokers (May 8, 2009).

[29] *See* Securities Exchange Act of 1934 §§ 17(b)(4)-(5).

Conclusion

SIFMA is encouraged by the Agencies' consideration of ways to harmonize the rules governing the futures and securities markets in the United States. SIFMA believes the Agencies should continue their open dialog to review the differences between their regulatory regimes and harmonize them where appropriate. The harmonization process should acknowledge the different needs of the securities and futures markets, preserve regulatory differences where they are justified and eliminate or soften them where they are not justified. SIFMA appreciates the opportunity to comment to help achieve this end. We urge the Agencies to issue an interim report by September 30, 2009 identifying the specific areas on which the Agencies intend to focus their efforts at harmonization. SIFMA would be pleased to provide further comments on any areas identified in such an interim report, or in any other forum that would be useful to the Agencies.

Sincerely,

Ira D. Hammerman
SIFMA Senior Managing Director and
General Counsel

cc (***via email***):

The Hon. Gary Gensler, Chairman, CFTC
The Hon. Mary L. Schapiro, Chairman, SEC
The Hon. Luis A. Aguilar, Commissioner, SEC
The Hon. Kathleen L. Casey, Commissioner, SEC
The Hon. Bart Chilton, Commissioner, CFTC
The Hon. Michael Dunn, Commissioner, CFTC
The Hon. Troy A. Paredes, Commissioner, SEC
The Hon. Jill E. Sommers, Commissioner, CFTC
The Hon. Elisse B. Walter, Commissioner, SEC