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BEFORE THE
UNITED STATES SENATE COMMITTEE ON
BANKING, HOUSING, AND URBAN AFFAIRS

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CEA Reauthorization

I. Introduction and Summary

Chairman Shelby, Ranking Member Sarbanes and Members of the Committee:

I am pleased to appear today to testify on behalf of the Securities and Exchange Commission ("Commission") to express the Commission's views on the Commodity Exchange Reauthorization Act of 2005, S. 1566, reported out of the Senate Agriculture Committee on July 29, 2005. My testimony will focus on those sections of S. 1566 that would affect the regulatory framework for security futures products established by the Commodity Futures Modernization Act of 2000 ("CFMA"), which is administered jointly by the CFTC and the SEC.

The Commission shares the concerns of this Committee's Chairman and Ranking Member expressed in their letter of July 20 to the Chairman of the Senate Committee on Agriculture, Nutrition and Forestry regarding Section 7 of S. 1566. The Commission supports the expansion of portfolio margining to all equity products but believes it should be accomplished without undermining the current requirements regarding comparability between security futures margin and options margin. The Commission also has serious concerns about the amendments in Section 8 of S. 1566. These changes would remove products currently considered securities from Commission oversight, thereby compromising both investor protection and market integrity and prohibiting securities exchanges from trading such instruments.

Finally, the President's Working Group on Financial Markets ("Working Group") has reached an agreement in principle on how to address the questions raised in the 7th Circuit's decision in CFTC v. Zelener. Commission staff has been working diligently with staff of the other members of the Working Group and has reached agreement on how to grant the CFTC targeted, additional anti-fraud authority, and an appropriate registration requirement for solicitors of retail foreign exchange contracts, that they believe would address Zelener without compromising legal certainty or competitive parity.

On this point, the Commission would especially like to thank the CFTC and its staff for their significant contribution to this effort. We fully support the CFTC in its efforts to combat retail foreign currency fraud.

II. Security Futures

A. Current Regulatory Framework

The Commodity Futures Modernization Act of 2000 ("CFMA") was a significant legislative achievement. Among other things, it lifted the ban on the trading of futures on single stocks and narrow-based indexes and established a framework for trading security futures products over which the CFTC and the SEC share regulatory authority. Its enactment was the product of much effort by Congress, the members of the Working

Group, and participants in the securities and futures industries. The SEC has a significant and legitimate interest in any legislative changes that affect the consensus achieved in the CFMA.

The ban on single stock futures was considered as part of the Working Group's 1999 report on OTC derivatives and the Commodity Exchange Act.[1] The report identified several important issues to be resolved before trading of single stock futures should be permitted, including issues about the integrity of the securities market and regulatory arbitrage. In December 1999, various members of Congress requested that the Chairmen of the SEC and CFTC formulate a legislative plan for lifting the ban on single stock futures. The legislative proposal negotiated by the Chairmen of the two agencies to eliminate the ban on single stock futures was transmitted to Congress by the Working Group in September 2000. Much of this proposal was incorporated into the bill that was enacted by Congress as the CFMA.

Under the joint regulatory framework established by the CFMA, security futures may trade on both futures and securities exchanges, as well as derivatives transaction execution facilities and alternative trading systems. Moreover, broker-dealers and futures commission merchants are both permitted to trade these products and offer them to their customers. While both agencies have enforcement and examination authority, it is clear that the CFTC is the lead regulator for futures markets and futures commission merchants and that the SEC is the lead regulator for securities broker-dealers and securities markets. Consultation between the two agencies generally is required when examinations or

[1] Report of the President's Working Group on Financial Markets, *Over-the-Counter Derivatives markets and the Commodity Exchange Act* (Nov. 1999) ("OTC Derivatives Report").

enforcement actions are undertaken, and examination reports of the lead regulator are to be used whenever possible.

The SEC staff has worked cooperatively with the CFTC in overseeing the market for security futures products. For example, our coordinated efforts to fulfill the objectives of the CFMA led to the establishment of a memorandum of understanding between the SEC and CFTC under which the two agencies agreed to share examination and trading-related information, coordinate examinations involving security futures activities, and notify each other concerning significant regulatory issues in the oversight of security futures products.

The SEC shares regulatory authority over security futures products because such products are surrogates for their underlying securities and therefore can be used to engage in frontrunning and manipulation in the underlying securities markets. For example, an investor who has agreed to sell a block of stock at the closing price could buy futures on that stock with the expectation of causing the stock's price to tick up at the close. In the same fashion, single stock futures and narrow-based security index futures have the potential to be used for insider trading and intermarket trading abuses, such as frontrunning and market manipulation. Because security futures are a substitute for their underlying securities and, therefore, have the potential to impact those underlying securities markets, the CFMA applies the securities laws to these products.

In addition, unlike many OTC derivative products, which are complex and relatively inaccessible to retail investors, security futures are readily available to retail investors. An intermediary can offer an investor either a security futures product or the securities underlying that product, or both. The CFMA recognizes that direct access to audit trails, coordinated market surveillance, and inspection authority, as well as suitability and customer protection regulation, are all necessary to the SEC's ability to regulate effectively and protect investors. Finally, the CFMA clearly provided that security futures could not be used to avoid the registration and disclosure provisions of the Securities Act of 1933 ("Securities Act").[2]

B. Changes to Regulatory Framework for Security Futures Products in S. 1566

The SEC believes that, if enacted, the changes to the current SEC-CFTC regulatory framework that are provided for in Sections 7 and 8 of the Commodity Exchange Reauthorization Act of 2005 would disrupt the jurisdictional balance and regulatory interaction that Congress, the members of the Working Group, and participants in the securities and futures industries have worked so hard to achieve, undermining both the accomplishments of the CFMA and our ability to protect investors and maintain market integrity. The SEC's specific concerns are discussed below.

1. Portfolio Margining

a. Importance of Comparability of Margin Requirements

The SEC supports the implementation of risk-based portfolio margining for all equity products. Under such a methodology, customer margin levels are determined by assessing the market risk of a "portfolio" of financial instruments taken as a whole. The advocates of this approach stress that portfolio margining results in customer margin requirements that more realistically reflect the risk to the broker-dealer of financing the customer's securities positions better than the current strategy-based methodology, which computes margin requirements for each individual position or strategy in a portfolio. Of

[2] *See* Section 2(a)(3) of the Securities Act, 15 USC 77b(a)(3).

course, this result depends on the accuracy of the models used to calculate risk, under normal and extreme market circumstances. While Section 7 of S. 1566 would permit security futures margin to be calculated using a portfolio margining methodology, it would do so by removing the current requirements regarding comparability between security futures margin and exchange-traded options margin, and eliminate the SEC's role in establishing margin requirements for security futures.[3]

Because of the balancing that is required to ensure equivalent margin treatment among related instruments, the SEC strongly believes that it would not be advisable for Congress to effect these changes to the joint regulatory framework for security futures through legislation. In fact, the SEC fears that these changes might lead to regulatory arbitrage between security futures and options. The amendments in Section 7 of S. 1566 would, for example, permit futures markets to establish portfolio margin requirements that treat unfavorably instruments held in a portfolio that were traded on a competing market. The SEC firmly believes that margin requirements should not be permitted to be used to gain a competitive advantage for securities futures over options.

The SEC believes that competition should be based on better products, services, and prices – not on regulatory differences. To avoid this possibility, the CFMA established that the margin requirements for security futures shall be no lower than margin requirements for comparable options contracts and that margin requirements would be set jointly by the SEC and CFTC.[4] These requirements were included to ensure

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3 Section 7 of S. 1566 would relieve certain markets trading security futures from the requirement to comply with the rules jointly adopted by the Commission and CFTC under Section 7(c)(2)(B) of the Exchange Act or any SRO rules pertaining to the levels of initial and maintenance margin that would preclude the implementation of portfolio margining.

4 Section 7(c)(2) of the Exchange Act directs the Board of Governors of the Federal Reserve System

that security futures were not provided a regulatory advantage over options and that exchanges would not compete on the basis of margin requirements. The changes in Section 7 of S. 1566 violate this principle and would provide security futures a regulatory advantage over securities options – products that are economic equivalents.

b. SEC Action

Importantly, if done imprudently, risk-based margining involves risks to the firms providing the margin, the investors, and the markets as a whole. For this reason, risk-based margining must be done carefully by the entity with the greatest familiarity with the issues involved. Therefore, other than initial margin requirements for stock, margin requirements in the securities markets are proposed, in the first instance, by the self-regulatory organizations, or SROs. The SROs are best able to draw on the expertise of their members in developing such proposals. The SEC believes this is a more prudent approach to implementing risk-based portfolio margining, but acknowledges that this has not been our top priority over the past few years. However, on July 14, 2005, the SEC approved companion proposals by the NYSE and the CBOE that permit their members, on a pilot basis, to compute certain customers' margin requirements using a portfolio margin methodology. These portfolio margin rules are limited to portfolios of financial instruments based on broad-based security indexes such as the S&P 500, NASDAQ 100, and the Russell 2000. Moreover, Chairman Cox has met recently with CFTC Chairman Jeffery and has committed to making the expansion of portfolio margining a priority.

("Federal Reserve Board") to prescribe rules establishing initial and maintenance customer margin requirements imposed by brokers, dealers, and members of national securities exchanges for security futures products. The Federal Reserve Board may delegate this rulemaking authority jointly to the Commission and the CFTC, which it did on March 6, 2001. The Commission and the CFTC adopted customer margin requirements for security futures on July 31, 2002. *See* Securities Exchange Act Release No. 46292, 67 FR 53416 (August 14, 2002) (File No. S7-16-01).

In taking steps to expand portfolio margining to a broader array of financial instruments, including single stock futures, narrow-based securities index futures and other equity securities, and a wider range of customer accounts, the SEC staff has been actively discussing with the securities industry and the NYSE an approach to portfolio margining that would both lower margin requirements and protect against systemic risk in the event of extreme market movements. The SROs have reinvigorated their efforts to allow for risk-based portfolio margining, and we anticipate that the NYSE and CBOE will propose to expand their portfolio margining pilot based on recommendations of a committee composed of representatives of the securities firms, the NYSE and CBOE.[5] Recently, this committee reached agreement on an approach to portfolio margining that allows its full benefits to be realized, while retaining the prudential benefits of margin requirements. Accordingly, we expect the SROs to file a proposal that would expand portfolio margining to include equity products.

c. Amendments to SIPA

The SEC believes that Congress can promote portfolio margining by targeted legislative changes to the Securities Investor Protection Act of 1970 ("SIPA"), which will encourage customers to take full advantage of new portfolio margining rules. The NYSE and CBOE portfolio margin rules necessarily have a cross-margin component under which futures and futures options can be combined with related securities to make up a portfolio, provided the futures positions offset securities positions. For example, a portfolio made up of securities based on the S&P 500 could include futures and futures

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[5] SEC, Federal Reserve Board, and CFTC staff have also been invited to participate as observers in meetings of this committee.

options based on the S&P 500 as well. Losses on the securities positions could be offset by gains on the futures positions to arrive at the customer's margin requirement.

Under the NYSE's and CBOE's rules, the securities and futures positions must be carried in a securities account to provide the customer with the protections of the securities laws and regulations. This raises an issue as to how the futures positions would be treated in a liquidation of the broker-dealer under the SIPA.

SIPA was enacted to protect customers of a failed broker-dealer. In general, it operates as a short-cut through the bankruptcy process, thereby providing the failed broker-dealer's customers with quicker access to their cash and securities. Part of this protection includes provisions for the trustee in the SIPA proceeding to make advances to customers up to $500,000 per customer to be used to return securities or cash that are missing or otherwise not available to be returned. Consistent with FDIC protection, only $100,000 of the $500,000 maximum can be used to return cash. The advances and the other costs of a SIPA liquidation are financed through a fund maintained by the Securities Investor Protection Corporation ("SIPC"). If the trustee does not recover the amounts advanced from the estate of the failed broker-dealer, the SIPC fund incurs the loss (rather than the customer who received the advance).

The SIPA protections apply to cash and securities held at a broker-dealer, but not to futures positions. This result is a function of the SIPA definition of "security," which specifically excludes futures. Moreover, there is no corresponding statutory protection for futures customers under which they would receive advances if futures assets are missing. Because, as noted above, the NYSE and CBOE rules permit futures and futures options to be included in a portfolio where they will hedge offsetting positions in related securities, the question is raised as to how the futures positions should be treated in a SIPA liquidation of the broker-dealer. The SEC believes they should be protected under SIPA because their inclusion lowers the risk of the portfolio as a whole.

To assure SIPA protection to all products in these accounts, the SEC recommends that Congress amend certain definitions in SIPA. Such amendments could be very narrowly tailored to, in effect, provide that futures (including options on futures) held in a portfolio margin account under a SEC approved portfolio margin rule would receive SIPA protection. Thus, the amendments would extend SIPC protection to those products that are permitted to be deposited into a portfolio margin account that are hedging offsetting securities positions and, therefore, lowering the broker-dealer's risk of carrying the financed customer positions.

2. Proposed Amendments Affecting the Definition of "Narrow-Based Security Index"

The SEC is concerned that the proposal in Section 8 of S. 1566 to amend the definition of narrow-based index would remove the SEC's jurisdiction over futures on certain security indexes, which we believe would negatively impact investor protection and market integrity. Specifically, Section 8 of S. 1566 would direct the SEC and CFTC to exclude from the definition of "narrow-based security index" indexes based on specified types of instruments: (a) indexes based on foreign and U.S. debt securities; (b) indexes based on foreign equity securities; and (c) other U.S. securities. The blanket exclusion in Section 8 would eliminate key protections currently provided by the federal securities laws, such as the registration and disclosure provisions of the Securities Act, to investors in futures based on the indexes (or the underlying securities) that this provision would exclude. Also, by excluding these indexes from the definition and giving the

CFTC exclusive jurisdiction over futures on such indexes, futures exchanges would have the exclusive right to trade these products, and securities exchanges would be precluded from trading such instruments. The impact of this proposal is described further below.

a. Indexes Based on Foreign and U.S. Debt

Prior to the proposal of legislation to exclude debt indexes from the definition of "narrow-based security index," no parties had expressed interest to the SEC in trading futures based on debt indexes. That said, we agree that the current statutory definition of "narrow-based security index" does not appropriately distinguish between broad-based and narrow-based indexes of debt instruments.[6] However, we do not believe that legislative changes are necessary to address this issue. In Section 3 of the Exchange Act, the limitations of the definition were contemplated by Congress, and joint authority was provided to the SEC and the CFTC to make determinations with respect to security indexes that do not meet the specific statutory criteria without regard to the types of securities that comprise the index.[7] The SEC and CFTC already have the tools necessary to exclude indexes composed of debt securities (U.S. or foreign), and we look forward to working with the CFTC to expeditiously address the trading of futures on debt indexes through joint action. To legislate such a change would make an unwarranted

[6] Specifically, an index is considered narrow-based if its lowest weighted component securities, in the aggregate, have average daily trading volume below $50 million ($30 million if the index has at least 15 securities). This requirement was intended to ensure that indexes of equity securities that are composed disproportionately of illiquid, and therefore more manipulable, securities are covered by the definition of "narrow-based security index." Individual debt securities do not trade with the same regularity as equity securities. Therefore, it would be very difficult to create a debt index that does not fall within the definition of "narrow-based security index" – even if that index would be widely considered broadly-based. Moreover, the frequency with which a particular debt securities trades is not a good indicator of whether it is susceptible to manipulation.

[7] *See* Section 3(a)(55)(C)(vi) of the Exchange Act, 15 USC 78c(a)(55)(C)(vi).

jurisdictional shift while limiting the flexibility of the two agencies to respond to interest in developing and trading new security futures products relating to debt indexes.

b. Foreign Security Indexes

Section 8 of S. 1566 would require the SEC and the CFTC to exclude from the definition of "narrow-based security index" indexes on foreign equities consistent with the capitalization, trading patterns, and trade reporting conditions in the foreign market. The SEC believes that it is important for the securities laws to apply to any index future that can be a surrogate for the index's component securities. A future on a narrow-based index composed of foreign securities can be a surrogate for underlying securities in the same way that a narrow-based index composed of domestic securities can be. Whether or not an index is a surrogate of its component securities depends on the number, concentration, and liquidity of the securities composing the index. The capitalization, trading patterns, or trade reporting conditions in a particular foreign market are not determinative of whether a future on a particular index could be a surrogate for the index's component securities.

Currently, the principal impediment to trading security futures on narrow-based indexes composed of foreign securities is the statutory requirement that all the securities underlying a security future be registered under Section 12 of the Exchange Act.[8] Because today all foreign stock indexes include unregistered securities, this requirement precludes U.S. exchanges from trading futures on such indexes if the indexes are "narrow-based." By moving the jurisdictional line to deem such indexes "broad-based," the requirement that underlying securities be registered under Section 12 would be

[8] 15 USC 78*l*.

removed. Thus, none of the protections of the securities laws would apply, including the prohibition on insider trading, raising market integrity and investor protection concerns. Moreover, redefining an index as broad-based would grant futures exchanges a monopoly to trade futures on such indexes because broad-based index futures may only trade on futures exchanges.

The SEC believes that there is an alternative way to address the impediments to trading these products as security futures (*i.e.*, the Section 12 registration requirement), and SEC staff has shared this approach with CFTC staff. Specifically, the SEC and the CFTC have the authority to exempt security futures from the requirement that underlying securities be registered under Section 12 of the Exchange Act. The SEC believes such an exemption would be appropriate under certain circumstances, including where such products are only available to sophisticated investors. The SEC and its staff would welcome the opportunity to work with the CFTC to resolve this issue.

c. Other U.S. Securities

Finally, Section 8 of S. 1566 would require the SEC and the CFTC to exclude from the definition of "narrow-based security index" indexes on other U.S. securities. It is unclear what this provision contemplates; yet it directs the two agencies to agree to change the jurisdictional line established by the CFMA.

Prior to the enactment of the CFMA, futures exchanges were permitted to offer a futures contract on a securities index only if the futures contract satisfied certain statutory criteria, including a requirement that the underlying securities index measure and reflect the entire market or a substantial segment of the market.[9] In addition to lifting

[9] The jurisdictional agreement, commonly referred to as the "Shad-Johnson Accord," was passed into law as part of both the Securities Acts Amendments of 1982 and the Futures Trading Act

the ban on trading of futures contracts if they did not satisfy these criteria, the CFMA's definition of "narrow-based security index" established a clear, objective standard for which indexes were narrow and which were broad. The SEC urges Congress not to reintroduce uncertainty into this area by establishing standards for determining jurisdictional boundaries that are subjective and subject to differing interpretations.[10] The SEC believes the current definition of "narrow-based security index" reasonably identifies those indexes of U.S. securities that are so small, highly concentrated, or illiquid that a future on such an index would be a surrogate for the underlying securities.

III. Application of CEA to Foreign Currency Transactions

A. Legal Certainty for OTC Derivatives Markets

It is widely recognized that OTC derivative instruments are important financial management tools that, in many respects, reflect the unique strength and innovation of U.S. capital markets. Indeed, U.S. markets and market professionals have been global leaders in derivatives technology and development. The enormous size of the OTC derivatives market demonstrates its critical role in our capital markets. OTC derivative instruments provide significant benefits to corporations, financial institutions, and institutional investors by allowing them to isolate and manage risks associated with their business activities or their financial assets. These instruments, for example, can be used

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of 1982. See P.L. No. 97-303; 96 Stat. 1409 (1982) and 97-444; 96 Stat. 2294 (1982). Under the Shad-Johnson Accord, the CFTC retained exclusive jurisdiction over all futures contracts on broad-based security indexes. The agreement prohibited the trading of single stock futures and futures on narrow-based security indexes.

[10] *See* Board of Trade of City of Chicago v. SEC., 677 F.2d 1137 (7th Cir. 1982), vacated as moot, 459 U.S. 1026 (1982); and Chicago Mercantile Exchange v. SEC, 883 F.2d (7th Cir. 1989); Board of Trade of the City of Chicago v. SEC, 187 F.3d 713 (7th Cir. 1999).

by corporations and local governments to lower funding costs, or by multinational corporations to reduce exposure to fluctuating exchange rates.

Legal certainty and regulatory clarity are essential to ensure that the U.S. continues to play a leading role with regard to innovation and growth in the OTC derivative market. An environment that lacks legal certainty could undermine the flexibility and competitiveness of the U.S. financial markets. The OTC Derivatives Report issued by the Working Group prior to the enactment of the CFMA contained several recommendations designed to address legal uncertainty regarding the application of the CEA to the execution and clearance of OTC derivatives products. In response, Congress sought in the CFMA to provide legal certainty and regulatory clarity in the OTC derivatives market. The SEC believes it is critical that these achievements be retained.

B. Proposed Amendments to Address Retail Foreign Currency Fraud

The SEC has worked closely with staff of the other members of the Working Group on issues related to the sale of foreign currency products to retail customers. The goal has been to give the CFTC clear authority to take action against foreign-exchange boiler rooms without undermining the so-called Treasury Amendment, which excludes certain transactions in foreign currency from CFTC jurisdiction.

This effort is a response to the Seventh Circuit's decision in CFTC v. Zelener,[11] upholding the dismissal of a CFTC fraud action on the grounds that certain leveraged contracts of sale for foreign currency marketed to retail customers were spot transactions, not futures contracts, and thus not subject to the CEA. As others have noted, the decision raised questions about the scope of the CFTC's jurisdiction under the Treasury

[11] 373 F.3d 861 (7th Cir. 2004).

Amendment. S. 1566 would address the Zelener decision by significantly expanding the jurisdiction of the CFTC.

The SEC believes that any change to the CEA should not be so broad as to affect the securities markets or the SEC's ability to effectively oversee those markets. In its current form, S. 1566 could do both by generating legal uncertainty regarding whether the CFTC would have jurisdiction over options on foreign currency that are traded on national securities exchanges and certain other securities, such as structured notes that reflect currency values. In addition, S. 1566 would undermine the competitive parity between broker-dealers and banks in foreign currency transactions that Congress established in 2000 with the CFMA. The securities and banking industries rely on parallel exclusions from the CEA that were fashioned by the CFMA for foreign currency transactions. However, S. 1566 would substantially curtail those exclusions for the securities industry by eliminating the exclusion for certain affiliates of broker-dealers. Because we have not seen evidence of involvement in retail foreign currency transaction fraud by these unregistered affiliates of broker-dealers, we do not believe it is appropriate to eliminate the exclusion.

The Working Group principals created a staff-level working group and directed their staff to work together to craft a legislative solution that would address the Zelener decision in a more targeted way than does S. 1566. The Working Group has reached agreement in principle on how to address the issues raised by this decision. The staff have met regularly over the past several weeks and is crafting legislative language that would grant the CFTC additional anti-fraud authority over a narrow category of leveraged transactions in foreign currency with retail customers by unregulated foreign exchange bucket shops, and a registration requirement for solicitors of such transactions. Important to the Commission is that this agreement would preserve the existing exclusion from the CEA for foreign currency transactions by certain broker-dealer affiliates, as well as other regulated financial institutions.

IV. Conclusion

The SEC appreciates the opportunity to participate in the dialogue that S. 1566 has engendered regarding security futures products and derivative products. We look forward to working closely with this Committee, the Working Group, market participants, and other legislators as these issues continue to be considered.