

2008

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### Recommended Citation

Richard Carlucci, *Harmonizing U.S. Securities and Futures Regulations*, 2 Brook. J. Corp. Fin. & Com. L. (2008).  
Available at: <https://brooklynworks.brooklaw.edu/bjcfcl/vol2/iss2/5>

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## NOTES

# HARMONIZING U.S. SECURITIES AND FUTURES REGULATIONS

### I. INTRODUCTION

The Securities and Exchange Commission (SEC) has authority over U.S. securities<sup>1</sup> markets, and the Commodity Futures Trading Commission (CFTC) has authority over U.S. futures<sup>2</sup> markets.<sup>3</sup> When the regulatory scheme for these markets first coalesced in the 1930s, there was a clear distinction between the instruments being traded on the two. Today, however, the boundary between securities and commodities is far more ambiguous. Traditional securities and commodities still exist, but a vast, complex array of instruments that are both futures and securities developed during and after the latter half of the 20th century. Futures on financial instruments now account for the vast majority of trading volume on futures markets.<sup>4</sup>

As a result of this evolution, the bifurcated scheme distinguishing securities from futures is outdated and should be overhauled. This note addresses the need for U.S. financial regulators to reform the system currently governing securities and futures, and asserts that the functions of the SEC and the CFTC should be merged into a single market regulator with uniform rules.

Part II of this note briefly recounts the development of the current system, and summarizes prior movements towards a unified regulatory agency. Part III explores the short-comings of the current approach towards regulation by detailing its disadvantages in the marketplace. Part IV analyzes several key areas where genuine reform of the underlying regulations is necessary, and proposes some solutions for a harmonized regulatory regime. Part V concludes this note by summarizing the importance of these issues.

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1. Securities include stocks, bonds, notes, treasury stocks, debentures, and a wide variety of other instruments. Securities Exchange Act, 15 U.S.C.A. § 78c(a)(10) (2006).

2. “Futures are agreements that obligate the holder to buy or sell a specific amount or value of an underlying asset, reference rate, or index at a specified price on a specified date. These contracts may be satisfied by delivery or by offset with another contract.” U.S. GEN. ACCOUNTING OFFICE, ISSUES RELATED TO THE SHAD-JOHNSON JURISDICTION ACCORD 1 n.2 (2000).

3. *Id.* at 5.

4. See Jerry W. Markham, *Super Regulator: A Comparative Analysis of Securities and Derivatives Regulation in the United States, the United Kingdom, and Japan*, 28 BROOK J. INT’L L. 319, 361 (2003).

## II. A SHORT HISTORY

The bifurcated regulatory system of U.S. markets, known colloquially as “functional” regulation,<sup>5</sup> owes its evolution to little more than the accidents of history. While the practice of futures trading traces its lineage back to the twelfth century, the regulatory history relevant to this note only goes back to Midwestern farmers who sought to hedge the risk of planting their crops around the turn of the twentieth century. The practice of securities trading has an equally lengthy pedigree, but similarly, this note focuses only on the modern regulatory environment, which has emerged since the Great Depression. Although both regimes developed upon separate but parallel tracks for the better part of half a century, there have been genuine, if unsuccessful, efforts in recent years to bridge the regulatory gap and combine the CFTC and SEC.

The Commodity Futures Trading Commission Act of 1974<sup>6</sup> created the CFTC as a response to commodity price inflation and several scandals in the trading of unregulated commodity options during the early 1970s.<sup>7</sup> That legislation updated and modernized the earlier Commodity Exchange Act of 1936,<sup>8</sup> which had proven ineffective at stopping the price manipulation it was created to combat.<sup>9</sup> The 1974 Act gave the CFTC “exclusive jurisdiction . . . with respect to accounts, agreements . . . and transactions involving contracts of sale of a commodity for future delivery, traded or executed on a contract market.”<sup>10</sup> That broad grant of authority eventually led to a series of disputes regarding the boundary between the CFTC and the SEC.<sup>11</sup> The now infamous Shad-Johnson Accords,<sup>12</sup> later codified into law,<sup>13</sup> addressed some of those conflicts, as did the Commodity Futures Trading Modernization Act of 2000.<sup>14</sup>

The SEC was created in 1934<sup>15</sup> to enforce the provisions of the Securities Act of 1933,<sup>16</sup> as well as several other important financial regulations.<sup>17</sup> These pieces of legislation were a direct response to the

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5. Melanie L. Fein, *Functional Regulation: A Concept for Glass Steagall Reform*, 2 STAN. J.L. BUS. & FIN. 89, 90 (1995).

6. Commodity Futures Trading Commission Act of 1974, Pub. L. No. 93-463, 88 Stat. 1389 (1974).

7. Markham, *supra* note 4, at 341.

8. Commodity Exchange Act of 1936, ch. 545, 49 Stat. 1491 (1936).

9. Markham, *supra* note 4, at 340-41.

10. Commodity Exchange Act, 7 U.S.C.A. § 2(a)1(a) (2000).

11. *E.g.*, Board of Trade of the City of Chicago v. SEC, 677 F.2d 1137 (7th Cir. 1982).

12. U.S. GEN. ACCOUNTING OFFICE, *supra* note 2.

13. An Act to Clarify the Jurisdiction of the Securities and Exchange Commission and the Definition of Security, and for Other Purposes, Pub. L. No. 97-303, 96 Stat. 1409 (1982); Futures Trading Act of 1982, Pub. L. No. 97-444, 96 Stat. 2294 (1983).

14. Commodity Futures Modernization Act of 2000, Pub. L. No. 106-554, 114 Stat. 2763 (2000).

15. 15 U.S.C.A. § 78d.

16. Securities Act of 1933, ch. 38, 48 Stat. 74 (1933) (codified at 15 U.S.C.A. §§ 77a-77aa).

17. *See* Markham, *supra* note 4, at 326 n.34.

Senate Banking Committee's investigation into the stock market crash of 1929,<sup>18</sup> and the subsequent emphasis placed on securities regulation by President Franklin Roosevelt.<sup>19</sup> Roosevelt was particularly concerned with the principle of full disclosure,<sup>20</sup> which has since become the cornerstone of modern securities regulation.<sup>21</sup> The SEC operates in tandem with a bevy of other actors to form a complex, multi-layered regulatory framework that includes non-governmental self-regulatory organizations (SROs), state attorneys general, and the various accounting firms and ratings agencies whose approval is necessary for listing on the exchanges.<sup>22</sup>

Despite their divergent histories and different functions, the recent past has seen at least one attempt to merge the two agencies in the form of the Markets and Trading Reorganization and Reform Act,<sup>23</sup> which was introduced and defeated in the House of Representatives by Representative Wyden in 1995 amidst lukewarm support from both agencies.<sup>24</sup> The bill would have ceded the functions of both the SEC<sup>25</sup> and CFTC<sup>26</sup> to a newly established Markets and Trading Commission,<sup>27</sup> and created an overarching Federal Financial Markets Coordinating Council,<sup>28</sup> composed of the heads of the Department of Treasury, Federal Reserve Board of Governors, Markets and Trading Commission, and other financial regulatory bodies.<sup>29</sup>

While the act was intended to bring some clarity and coordination to financial regulation,<sup>30</sup> with the exception of the ability to change margin requirements<sup>31</sup> it gave the Markets and Trading Commission no authority to resolve any of the underlying regulatory conflicts that gave rise to the need for clarity and coordination in the first place.<sup>32</sup> In the end, it was little more

18. JOEL SELIGMAN, *THE TRANSFORMATION OF WALL STREET* 13 (1982).

19. *Id.* at 51–53.

20. “Let in the light!” *Id.* at 20, 40.

21. *Id.*

22. See Markham, *supra* note 4, at 325–38 (fully discussing the relations among these actors).

23. Markets and Trading Reorganization and Reform Act, H.R. 718, 104th Cong. (1995).

24. *Markets and Trading Reorganization and Reform Act: Hearing on H.R. 718 Before the Subcomm. on Capital Markets, Securities, and Gov't Sponsored Enterprises of the H. Comm. on Banking and Financial Services*, 104th Cong. (1995) (statement of Arthur Levitt, Chairman, SEC).

25. H.R. 718 § 202.

26. H.R. 718 § 201.

27. H.R. 718 § 101.

28. H.R. 718 § 301.

29. H.R. 718 § 301(b).

30. “The purposes of this act are . . . to establish a single federal regulatory body . . . to coordinate the regulation of all financial markets . . . and . . . to ensure the competitiveness of those markets.” H.R. 718 § 2.

31. H.R. 718 § 203.

32. H.R. 718 § 411.

[T]he Commission . . . may exercise any authority available by law . . . with respect to such function to the official or agency from which such function is transferred, and the actions of the Commission in exercising such authority shall have the same force and effect as when exercised by such official or agency.

than a glorified reshuffling of the existing bureaucracy<sup>33</sup> and its failure to address the underlying regulatory issues was considered a significant flaw.<sup>34</sup>

The issue has been raised again, however, as legislators continue to be frustrated by the inefficiencies of the bifurcated system.<sup>35</sup> There is concern that an outright merger of the SEC and CFTC is “probably a bridge too far,”<sup>36</sup> but it has not swayed industry advocates from pressing for comprehensive reform.<sup>37</sup> The consensus amongst Congress and the securities and commodities industries appears to be that the rules need to be harmonized, which would accomplish in substance what the Markets and Trading Reorganization and Reform Act attempted to do in form.

### III. DUELING AGENCIES HELP NO ONE

Bifurcation of the regulatory system was once a common-sense, efficient method of oversight because of the clear distinction between the products traded on securities markets versus those traded on futures markets.<sup>38</sup> Recent innovations have significantly blurred the lines between the two areas, however, and created considerable regulatory uncertainty among investors, regulators, and financial institutions. Some professionals even attest that this uncertainty has been detrimental to the formation of new products on the markets.<sup>39</sup> The costs and uncertainty that have befallen those who did attempt to innovate, such as the Chicago Board of Trade,<sup>40</sup> provide a concrete example of the burdensome ordeal that awaits any product that cuts across the clear regulatory distinctions the two agencies prefer to maintain. These regulatory hurdles are even seen by some as a reason for the decline in U.S. competitiveness in relation to other financial markets around the world.<sup>41</sup> Although they may not speak directly to the problem, recent attempts by SROs to reduce overlapping regulations by harmonizing their rules and combining their enforcement functions is a

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*Id.*

33. See generally H.R. 718 §§ 412–13 (giving the Commission the power to delegate tasks and reorganize the various administrative entities within the existing bureaucracy).

34. *Financial Market Regulation: Benefits and Risks of Merging the SEC and CFTC: Hearing Before the Subcomm. on Capital Markets, Securities and GSEs of the H. Comm. on Banking and Financial Services*, 104th Cong. 6 (1995) (statement of James Bothwell, Director, Financial Institutions and Markets Issues, U.S. Gen. Accounting Office) [hereinafter Bothwell Testimony].

35. *Study Sought on Blending SEC, CFTC*, FINANCIAL ADVISOR, July 12, 2007, [http://fa-mag.com/news.php?id\\_content=4&idNews=1021](http://fa-mag.com/news.php?id_content=4&idNews=1021).

36. *Id.* (quoting Sen. Jack Reed).

37. Gary DeWaal, *America Must Create a Single Financial Regulator*, FIN. TIMES, May 19, 2005, at 13.

38. Markham, *supra* note 4, at 346.

39. See DeWaal, *supra* note 37.

40. See *infra* note 45.

41. See generally MCKINSEY & CO., SUSTAINING NEW YORK’S AND THE US’ GLOBAL FINANCIAL SERVICES LEADERSHIP 78–85 (2007).

clear indicator that the markets are over-burdened by excessive, and sometimes contradictory, regulations.<sup>42</sup>

Regulatory confusion with regard to many emerging instruments stems from the hap-hazard division of authority between the two agencies. The CFTC was broadly given “exclusive jurisdiction . . . with respect to accounts, agreements . . . and transactions involving contracts of sale of a commodity for future delivery, traded or executed on a contract market . . . or derivatives transaction execution facility registered pursuant to”<sup>43</sup> the Act. Unfortunately, this grant of power would have easily encompassed many securities products (such as puts and calls on individual stocks) in the absence of vague limitations intended to carve out a niche for the SEC.<sup>44</sup> Despite the fact that various instruments that were both securities and futures existed at the time these regulations were first promulgated, Congress failed to make any clear distinction between the authorities of the two agencies to regulate them.<sup>45</sup>

The most famous dispute generated by this ambiguous bifurcation was the battle between the SEC and the CFTC in *Board of Trade of the City of Chicago v. SEC*.<sup>46</sup> There, the Board of Trade (with support from the CFTC) challenged the approval given to the Chicago Board Options Exchange (CBOE) by the SEC to create a market for exchange-formed off-set options in government national mortgage associations (GNMAs, also known as Ginnie Maes), arguing that only the CFTC had the authority to give such permission.<sup>47</sup> The dispute coalesced because, at the time, the CFTC had banned the trading of options on exchanges it governed, which included the Board of Trade but not the CBOE, which was governed by the SEC.<sup>48</sup> The court noted that the options in question were technically both “securities” and “commodities,”<sup>49</sup> but concluded that the exclusive jurisdiction given to the CFTC to regulate commodities trumped any potential jurisdictional

42. Gaston F. Ceron, *Moving the Market: NASD, NYSE Regulatory Arm Plan Oversight Entity*, WALL ST. J., Nov. 10, 2006, at C3.

43. Commodity Exchange Act, 7 U.S.C.A. § 2(a)(1)(A) (2007).

44. The carve-out appears intentionally broad, claiming that “nothing contained in this section shall (1) supersede or limit the jurisdiction at any time conferred on the Securities and Exchange Commission.” 7 U.S.C.A. § 2(a)(1)(A); *accord* 7 U.S.C.A. § 2(a)(1)(C).

This chapter shall not apply to and the Commission shall have no jurisdiction to designate a board of trade as a contract market for any transaction whereby any party to such transaction acquires any put, call, or other option on one or more securities . . . including any group or index of such securities, or any interesting therein or based on the value thereof.

*Id.*

45. *See* Bd. of Trade of the City of Chi. v. SEC, 677 F.2d 1137, 1148 (7th Cir. 1982); U.S. GEN. ACCOUNTING OFFICE, *supra* note 2, at 5 (discussing the significance of the case).

46. 677 F.2d at 1148.

47. *Id.* at 1140–41.

48. *Id.* at 1143–45.

49. *Id.* at 1142 (citing 15 U.S.C.A. § 78c(a)(10) and 7 U.S.C.A. § 2).

claim by the SEC based on a finding that “GNMA’s are not traditional stocks and GNMA options have the character of a legitimate commodity derivative.”<sup>50</sup>

Although the case was deemed moot on appeal when the two agencies reached an informal agreement to share authority in the Shad-Johnson Accord,<sup>51</sup> the fundamental conflict remains. A bifurcated regulatory system, designed for the distinctly different markets of the 1930s, is ill-equipped to handle the needs and challenges of increasingly complex and intertwined markets in the twenty-first century. Even if costly disagreements over new products could be avoided, there is still concern that bifurcation ignores the linkages between the two markets to the detriment of the economy, leading to events like the stock market crash of 1987.<sup>52</sup>

There is also some indication that the United States is losing ground to other financial centers, like London, because of the burdens of bifurcated regulation. Much of the criticism in this area is directed at the Sarbanes Oxley Act of 2002<sup>53</sup> and the burdens it placed on public equity offerings, particularly as evidenced by the sharp reduction in U.S. initial public offerings (IPOs) in recent years.<sup>54</sup> However, there have also been suggestions that those problems have combined with the rise in derivatives trading over the past few years to make markets with unified regulatory schemes, like London, much more attractive centers of investment.<sup>55</sup> Using the example of a common hedge fund in a recent *Financial Times* op-ed, one commentator argued for unified regulation by noting that when “trad[ing] both equities and futures, its positions are monitored under separate regulatory environments subject to different rules” in the United States, as compared to the United Kingdom, where “a hedge fund can maintain both . . . positions in one regulatory environment.”<sup>56</sup>

Although it does not speak directly to the issue at hand, the recent decision by the NYSE and the NASD to “consolidate their member regulation operations”<sup>57</sup> under a uniform banner is a sure signal from the private sector that the financial markets are over-regulated. Indeed, combating over-regulation was one of the major motivators of the merger.<sup>58</sup> NASD Chairman Mary Schapiro noted that one of the plan’s aims was to

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50. *Id.* at 1152.

51. U.S. GEN. ACCOUNTING OFFICE, *supra* note 2, at 6.

52. *See generally* REPORT OF THE PRESIDENTIAL TASK FORCE ON MARKET MECHANISMS (1988) (popularly known as “The Brady Commission Report”) [hereinafter BRADY COMMISSION REPORT].

53. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 805 (2002).

54. COMM. ON CAPITAL MKTS. REGULATION, INTERIM REPORT 2 (2006).

55. DeWaal, *supra* note 37.

56. *Id.*

57. Press Release, Fin. Indus. Regulatory Auth., NASD and NYSE Group Announce Plan to Consolidate Regulation of Securities Firms (Nov. 28, 2006), *available at* <http://www.finra.org/PressRoom/NewsReleases/2006NewsReleases/P017973>.

58. *Id.*

effectuate “a more sensible and less complex regulatory regime that makes private sector regulation more efficient and effective.”<sup>59</sup> SEC Chairman Christopher Cox echoed her comments, citing efforts toward “eliminating overlapping regulation, establishing a uniform set of rules, and placing oversight responsibility in a single organization” as key strengths of the merger.<sup>60</sup> These advantages are nearly identical to some of those advocated nearly twenty years ago by the then Commissioner of the SEC when speaking of the potential for merging that organization with the CFTC.<sup>61</sup>

#### IV. REFORM OF THE UNDERLYING REGULATIONS

Although the notion of merging the SEC and CFTC is not necessarily new, prior proposals have envisioned a bureaucratic reshuffling that would coordinate their enforcement activities, but leave in place the bifurcation of the underlying securities and futures regulations.<sup>62</sup> While this might technically eliminate some much-lamented jurisdictional battles, it would not bring any uniformity to the marketplace, and would “continue to require teams of investigators and attorneys with specialized expertise in both futures and securities laws and markets regardless of whether they are housed in one or two agencies.”<sup>63</sup> Despite the small advantages such a reshuffling might provide, investors looking to trade in futures and securities would continue to maintain separate accounts, typically overseen by separate advisors, subject to separate regulatory regimes. Genuine reforms that would allow investors to maintain one account, with one advisor, and subject to only one regulatory regime, can only be achieved by harmonizing futures and securities regulations. Although there are numerous points of conflict, priority should be placed on harmonizing the areas of margin requirements, suitability rules, account protections, insider trading, and broker-dealer and futures commission merchant (FCM) registration.

##### A. MARGIN REQUIREMENTS

Authority over securities margin requirements is officially delegated to the Board of Governors of the Federal Reserve Bank, with an eye towards “preventing the excessive use of credit for the purchasing or carrying of securities.”<sup>64</sup> The Board of Governors has issued margin requirements and

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59. *Id.*

60. *Id.*

61. Mary L. Schapiro, Comm’r, SEC, Remarks Before the Law and Compliance Division of the Futures Industry Association (May 3, 1990). This is surely not a coincidence, as the Commissioner at that time was the same Mary Schapiro who now heads the NASD.

62. *See supra* Part II.

63. Bothwell Testimony, *supra* note 34, at 3.

64. 15 U.S.C.A. § 78g(a) (2006).



related rules pursuant to Regulation T,<sup>65</sup> requiring a margin of anywhere from 50% to 150% of the value of the securities involved in the transaction<sup>66</sup> to be deposited within five business days of its execution.<sup>67</sup> “The primary purpose of the margin requirements was to provide the Board with an effective method of reducing the amount of the Nation’s credit resources which could be directed by speculation into the stock market.”<sup>68</sup> The margin requirements are thus quite high, as “it is the public policy of the United States . . . to discourage and prevent the purchase of stock on extended credit.”<sup>69</sup> By contrast, authority over futures margin requirements is delegated to the contract markets themselves,<sup>70</sup> or to self-regulating registered futures associations,<sup>71</sup> such as the National Futures Association (NFA).<sup>72</sup> Although margin levels vary slightly by exchange, and even by commodity, they are typically about 5% of the value of the underlying futures contract.<sup>73</sup>

These vastly different margin requirements appear to be the result of the different roles played by margin in the securities and futures industries. In case of the former, it is considered a down payment on the purchase of an asset, while in the latter case it is considered a performance bond on the obligations set out in the underlying contract.<sup>74</sup> In addition, the higher

65. 12 C.F.R. § 220.1 (2008).

66. 12 C.F.R. §220.12(a)–(f). *But see* 15 U.S.C.A. § 78g(c)(2)(B) (allowing the SEC and CFTC to jointly regulate margin requirements for securities–futures products and comparable options contracts authorized by 15 U.S.C.A. § 78f(a)).

67. 12 C.F.R. § 220.4(c)(3)(i). *But see* 12 C.F.R. § 220.4(c)(3)(ii) (allowing extension of the payment period in five–day increments upon application to the applicable governing exchange or SRO).

68. *Moscarelli v. Stamm*, 288 F.Supp. 453, 458 (E.D.N.Y. 1968); *Stonehill v. Sec. Nat’l Bank*, 68 F.R.D. 24, 31 (S.D.N.Y. 1975).

The “main purpose” of the margin rules was to regulate the volume of credit flowing into the securities market: “The main purpose is to give a Government credit agency an effective method of reducing the aggregate amount of the nation’s credit resources which can be directed by speculation into the stock market and out of other more desirable uses of commerce and industry—to prevent a recurrence of the pre-crash situation where funds which would otherwise have been available at normal interest rates for uses of local commerce, industry and agriculture, were drained by far higher rates into security loans and the New York call market.”

*Id.* (quoting H.R. Rep. No. 1383, 73d Cong., 2d Sess. 8 (1934)); *accord* 15 U.S.C.A. § 78g(a) (2006) (“For the purpose of preventing the excessive use of credit for the purchase or carrying of securities . . .”).

69. *Klein v. D.R. Comenzo Co.*, 207 N.Y.S.2d 739, 740 (N.Y. Mun. Ct. 1960).

70. 7 U.S.C.A. § 7(d)(11) (2007) (“financial integrity of contracts”).

71. 7 U.S.C.A. § 7a-2(b) (“delegation of functions under core principles”).

72. The NFA is the largest of such self–regulating associations, however its margin authority is in turn delegated to its member contract markets. *See* National Futures Association Manual ¶ 7007 (1999), <http://www.nfa.futures.org/nfaManual/manualFinancial.asp#fins7>.

73. NAT’L FUTURES ASS’N, OPPORTUNITY AND RISK: AN EDUCATION GUIDE 27 (2006), available at <http://www.nfa.futures.org/investor/OppRisk/OppRisk.pdf>.

74. Dana Atwood Lukens, Note, *Regulation for the Securities Markets?*, 10 ANN. REV. BANKING L. 379, 413 (1991).

requirements in securities markets are thought to help curb volatility,<sup>75</sup> a condition the futures markets are not preoccupied with limiting.<sup>76</sup>

The sheer magnitude of the discrepancy between the two margin levels might be difficult to reconcile, but it is not impossible. Securities-futures products, for example, are already subject to identical margin requirements regardless of whether they are traded on securities or futures exchanges.<sup>77</sup> Moreover, in the wake of the 1987 Crash, margin harmonization was suggested as an efficient way to prevent another meltdown.<sup>78</sup>

The issue, therefore, is whether harmonized margins should be closer to the current futures or securities level. Recent scholarship that calls into question the classic assumption that higher margin requirements are an effective method of reducing stock market volatility may offer a partial answer.<sup>79</sup> There is significant evidence that volatility in the markets leads to changes in margin requirements, in direct contrast to the conventional wisdom that the relationship operates in the other direction.<sup>80</sup> As a result, one of the justifications for keeping securities margins so high is no longer as convincing as it once was.<sup>81</sup>

On the other hand, lower rates do tend to result in greater credit allocation to securities and futures speculation.<sup>82</sup> Although preventing this was the major concern of Congress when it originally enacted securities margin requirements, the overall percentage of the nation's credit that is directed towards securities speculation is so low that it ceases to be a credible concern.<sup>83</sup> Consequently, and in light of the fact that higher requirements tend to decrease the liquidity that futures markets need to

75. *Id.*

76. Markham, *supra* note 4, at 363 (“Futures are not needed for commodities with stable prices. Such commodities do not need the benefits of hedging, and speculators are uninterested because there is no profit to be made from a stable price.”). *But see* 7 U.S.C.A. §6a(a) (“Sudden or unreasonable fluctuations or unwarranted changes in the price of . . . [commodities are] an undue and unnecessary burden on interstate commerce.”).

77. 7 U.S.C.A. § 2(a)(1)(C)(v)(IV).

It shall be unlawful for any futures commission merchant to, directly or indirectly, extend or maintain credit to or for, or collect margin from any customer on any security futures product unless such activities comply with the regulations prescribed pursuant to section 7(c)(2)(B) of the Securities Exchange Act of 1934.

*Id.*

78. BRADY COMMISSION REPORT, *supra* note 52, at vii.

79. PAUL H. KUPIEC, BD. OF GOVERNORS OF THE FED. RESERVE SYS., MARGIN REQUIREMENTS, VOLATILITY, AND MARKET INTEGRITY: WHAT HAVE WE LEARNED SINCE THE CRASH? 8 (1997).

80. *Id.* at 29–31.

81. *See supra* note 75 and accompanying text.

82. KUPIEC, *supra* note 79, at 32.

83. Robert J. Malloy, *Margin Regulation: The Stock Market Crash of 1987*, 20 RUTGERS L.J. 693, 701 (1989) (noting that Federal Reserve studies indicate less than 3% of the nation's credit is allocated towards securities speculation).

function properly,<sup>84</sup> a harmonized margin requirement settled at a rate closer to the lower rates currently seen in futures markets seems more appropriate.<sup>85</sup>

## B. THE SUITABILITY REQUIREMENT

Another key distinction between the two regulatory schemes is the so-called “suitability requirement” of the securities industry, whereby broker-dealers have a fiduciary duty not to recommend unsuitable investments to their customers when dispensing investment advice.<sup>86</sup> While federal securities laws do not explicitly impose such a duty, securities SROs have promulgated rules to this effect pursuant to the SEC’s anti-fraud rule, 10b-5.<sup>87</sup> The federal courts and the SEC have likewise found and enforced a suitability requirement under Rule 10b-5.<sup>88</sup> The basic premise of the rule is that when broker-dealers stand in a position of trust and confidence to their clients and make recommendations,<sup>89</sup> if they know that any of those

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84. KUPIEC, *supra* note 79, at 5–6 (suggesting that the Federal Reserve Bank, the CFTC, and the Treasury department share concerns over the negative effect that increased margin requirements would have on futures market liquidity).

85. *Id.* at 5 (noting that the Brady Commission, in the wake of the 1987 Crash, suggested that harmonization would be helpful, but refused to recommend increasing futures margins to match securities margins—implying that a lowering of securities margins was perhaps more appropriate).

86. There is considerable scholarly debate surrounding the precise theory of liability upon which the “suitability requirement” rests. The full range of that discussion is far beyond the scope of this note, however, and it is sufficient for these purposes that the doctrine itself is universally accepted.

87. 17 C.F.R. § 240.10b-5 (2007).

It shall be unlawful for any person, directly or indirectly, to: (a) employ any device, scheme, or artifice to defraud; (b) make any untrue statement of a material fact or omit to state a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading, or (c) engage in any act, practice, or course of business that operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of a security.

*Id.*; see NASD Rule 2310 (“broker-dealer must have reasonable basis for believing that a recommendation is suitable for a customer, given the information known or provided by the customer”).

88. *Olde Discount Corp.*, 67 SEC Docket 2045, 1998 WL 575171, at \*20–21 (1998); *City of San Jose v. Paine, Webber, Jackson & Curtis Inc.*, No. 84-20601, 1991 WL 352485, at \*1–2 (N.D. Cal. 1991); *Clark v. John Lamula Investors, Inc.*, 583 F.2d 594, 600 (2d Cir. 1978); see also *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 193 (1976) (holding that mere negligence is insufficient to sustain a cause of action under 10b-5, but that such an action requires an intent to deceive).

89. Courts are divided over whether or not a customer must have a discretionary account, where the broker-dealer is responsible for buying and selling on behalf of the client, in order to trigger the suitability requirement. Typically it will be enough to assert that a broker-dealer was held in trust and confidence by the client, and that his recommendations were followed as a result of that relationship. For a fuller discussion of this debate, see *Baker v. Wheat First Sec.*, 643 F.Supp. 1420, 1428–29 (S.D. W.Va. 1986).

recommendations is unsuitable they must inform their client.<sup>90</sup> In order to facilitate that determination, SEC rules require the collection of information from each individual customer regarding income, net worth, investment objectives, and employment status.<sup>91</sup> Violation of this requirement, like all 10b-5 fraud violations, can result in a private action and civil liability.<sup>92</sup>

Despite the similarity between the anti-fraud provisions of the Commodity Exchange Act and those of the Securities Exchange Act,<sup>93</sup> however, courts and the CFTC have held that “no rule of suitability governs the commodity broker-customer relationship under the Commodity Exchange Act or under the regulations adopted by the CFTC.”<sup>94</sup> The CFTC did attempt to institute a formal suitability requirement in the late 1970s, but it was defeated, perhaps by industry pressures, in favor of a far more modest risk-disclosure requirement.<sup>95</sup> Its official position was that it was “unable . . . to formulate meaningful standards of universal application.”<sup>96</sup>

Although the NFA has adopted a “know your customer” rule,<sup>97</sup> it is considered a business-conduct standard rather than an anti-fraud rule and creates no private right of action,<sup>98</sup> in contrast to the 10b-5-based securities rules. The rule requires information-gathering from customers only so that the FCM will know what level of risk disclosure is appropriate for each customer, but it emphasizes that it is for the customer to decide whether any particular trade is suitable.<sup>99</sup> This focus is intended to absolve FCMs of a

90. *Clark*, 583 F.2d at 600; *accord* *Rolf v. Blyth, Eastmon Dillan & Co.*, 570 F.2d 38, 44–48 (2d Cir. 1978) (holding that the suitability requirement is violated when a broker–dealer who has a duty to his client is reckless in his recommendations).

91. *See* 17 C.F.R. § 240.17a-3(a)(17)(i)(A) (2007).

92. *Kardon v. Nat’ Gypsum Co.*, 69 F.Supp. 512, 513–14 (E.D. Pa. 1946).

93. *Trustman v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, No. CV-82-6701, 1985 WL 28, at \*14 (C.D. Cal. 1985) (“Because § 4(b)(A) is the commodities counterpart of § 10(b) and Rule 10b-5, the elements of a claim under § 4(b)(A) are basically the same as those under Rule 10b-5.”).

94. *Id.* at 15; *accord* *Phacelli v. Conticommodity Servs., Inc.*, No. R80-385-80-704, 1986 WL 68447, at \*8–9 (C.F.T.C. Sept. 5, 1986).

95. *Markham*, *supra* note 4, at 355.

96. Adoption of Customer Protection Rules, 43 Fed. Reg. 31,886, at 31,888 (July 24, 1978).

97. Nat’l Futures Ass’n, Rule 2–30, Customer Information and Disclosure, *available at* <http://www.nfa.futures.org/nfaManual/manualCompliance.asp#2-30> (last visited Oct. 23, 2007).

98. NFA Interpretive Notice, NFA Compliance Rule 2–30: Customer Information and Risk Disclosure (June 1, 1986), *available at* <http://www.nfa.futures.org/nfaManual/manualInterp.asp#InterpretiveNotices> (last visited Oct. 23, 2007).

NFA’s enactment of the Rule 2–30 should not be construed to expose Members to increased potential liability for damages in customer litigation or reparation proceedings, for several reasons. First, a business conduct standard promulgated by a self-regulatory organization does not create a private cause of action. Furthermore, Rule 2–30 is not an antifraud rule.

*Id.*

99. *Id.*; *see also* Andrew M. Pardieck, *Kegs, Crude and Commodities Law: On Why It Is Time to Re-examine the Suitability Doctrine*, 7 NEV. L.J. 301, 346 (2007) (discussing the NFA’s historic opposition to any rules that would impose liability upon futures industry professionals).

duty to make suitable recommendations and prevent their exposure to liability in the case of customer litigation.<sup>100</sup>

Harmonized regulation requires that this discrepancy between securities and futures rules be solved, and there is little reason to consider a satisfactory resolution out of reach. A possible solution that one prominent scholar has proposed would require advisors to use objective measures of wealth and income to make a blanket determination of whether futures trading is per se unsuitable for an individual investor.<sup>101</sup> This rule is premised on the notion, currently espoused by both the CFTC and the NFA, that all futures contracts are risky and that meaningful distinctions cannot be made amongst them.<sup>102</sup> However, although this might be an attractive rule from an administrative standpoint, it would cut against the individualized inquiry that is called for under the suitability requirements of the securities industry,<sup>103</sup> maintaining a substantive difference between securities and futures trading and thereby defeating the purpose of harmonization.<sup>104</sup>

Another approach, which the CFTC at one time recommended in a failed attempt to impose suitability requirements on the futures industry, would be to make an initial determination of per se suitability, and then a determination of the suitability of any particular trade.<sup>105</sup> The second part of this test is similar to the securities industry's highly individualized suitability requirement, which is helpful for the purposes of harmonization. But the first part is a blanket determination of the kind just rejected above, and would again defeat the purpose of harmonization by creating a formal wall between futures and securities for many customers.

A more reasonable solution would be to simply impose the same suitability requirements on FCMs as are currently imposed on broker-dealers. Having an identical rule is the best possible outcome for the purposes of harmonization.<sup>106</sup> More importantly, adopting a formal

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100. NFA Interpretive Notice, NFA Compliance Rule 2-30: Customer Information and Risk Disclosure (June 1, 1986), <http://www.nfa.futures.org/nfaManual/manualInterp.asp#InterpretiveNotices>.

101. Pardieck, *supra* note 99, at 344.

102. *Id.* at 342-43.

103. *See supra* note 91.

104. A blanket determination that some customers simply cannot trade in particular instruments goes far beyond even the most stringent SEC suitability requirements. *See* JERRY W. MARKHAM, 13 COMMODITIES REGULATION: FRAUD, MANIPULATION, & OTHER CLAIMS § 10:1 (2008) (emphasizing the subjective, individual determination required by the SEC rule).

105. *See* Pardieck, *supra* note 99, at 343 (citing Standards of Conduct for Commodity Trading Professionals, 42 Fed. Reg. at 44,750). Note the evolution of the CFTC's position: at one time advocating a two-tiered suitability determination, and at another arguing that suitability is inappropriate because all futures contracts are risky.

106. Note that FCMs are subject to a suitability requirement similar to that of the SEC when trading in security-futures products, so they are already familiar with its application. NFA Rule 2-30(j)(4): Customer Information and Disclosure, <http://www.nfa.futures.org/nfaManual/manualCompliance.asp#2-30>.

suitability rule will accomplish in form what many think is already occurring in substance: Administrative law judges and the CFTC have a habit of searching for “material misrepresentations of risk” when fact patterns suggest unsuitable recommendations by FCMs.<sup>107</sup> Federal courts have also rendered decisions that appear to mask suitability claims under the cloak of material misrepresentations of risk.<sup>108</sup> Moreover, the arguments against this kind of formal suitability rule in the futures industry are simply not very compelling. Although the NFA and CFTC are right to point out that risk is inherent in all futures contracts, commentators have been quick to retort that making meaningful distinctions based on factors such as the structure or size of a transaction is not terribly difficult.<sup>109</sup> The CFTC itself argued as much when it first attempted to impose suitability rules.<sup>110</sup> Imposing the securities industry’s suitability rules uniformly across both industries therefore appears to be a reasonable and relatively simple route towards harmonization.

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### C. INVESTMENT ACCOUNT PROTECTION

Securities accounts are protected from the failure of the broker-dealers who administer them by the Securities Investment Protection Act of 1970 (SIPA).<sup>111</sup> That act was a response to the failure of a “significant number of brokerage firms” in the late 1960s, which saw the assets and investments of many consumers either lost or frozen as those firms went bankrupt.<sup>112</sup> The Act created the Securities Investment Protection Corporation (SIPC), which is authorized to appoint a trustee for the purpose of liquidating a brokerage firm in the event that it is, or will soon be, unable to continue operating.<sup>113</sup> In such a proceeding, the SIPC places a high priority on returning to customers the property they have deposited at the firm,<sup>114</sup> and guarantees customer assets up to \$500,000, including up to \$100,000 in cash,<sup>115</sup> using funds collected by the SIPC from all member firms.<sup>116</sup>

Futures accounts do not enjoy parallel protections. Although the Commodity Exchange Act (CEA) prohibits FCMs from using one customer’s funds to maintain margin calls on another customer’s

107. See Pardieck, *supra* note 99, at 326–30; accord MARKHAM, *supra* note 104, at § 10:7.

108. *E.g.*, Schofield v. First Commodity Corp. of Boston, 793 F.2d 28, 34–36 (Mass. 1986); accord Crook v. Shearson Loeb Rhoades, Inc., 591 F.Supp. 40, 48–49 (D. Ind. 1983).

109. See Pardieck, *supra* note 99, at 343.

110. *Id.* at 343 (quoting the CFTC that “If the professional thought the risk of buying 10 contracts was too great, the proper recommendation might be to purchase fewer contracts.”).

111. Pub. L. No. 598, 84 Stat. 1636 (1970).

112. *Sec. Investor Protection Corp. v. Barbour*, 421 U.S. 412, 415 (1975).

113. See 15 U.S.C.A § 78eee (2006).

114. 15 U.S.C.A § 78fff-2(c)(1).

115. 15 U.S.C.A § 78fff-3(a).

116. See 15 U.S.C.A § 78ddd (regarding the establishment of the SIPC fund).

positions,<sup>117</sup> and although customer funds must be segregated from the FCM's own funds,<sup>118</sup> they may be commingled with the funds of other customers<sup>119</sup> and there is no central insurance system akin to the SIPA to protect customer assets in the event that an FCM goes under.<sup>120</sup> Special bankruptcy rules require that segregated customer funds, to the extent they are available, must be paid back to the customer to whom they belong on a pro rata basis when an FCM goes bankrupt,<sup>121</sup> but there is no guarantee that the available funds will be sufficient to meet those obligations. Those same rules also direct trustees in a bankruptcy proceeding to transfer customers' open positions to solvent FCMs with whatever funds are available in the same pro rata fashion,<sup>122</sup> but again there is no guarantee that sufficient funds will be available to achieve this. The net result of this arrangement is that "the entire segregated account is at risk when one customer places trades that he cannot cover and that are too large for the broker to cover either."<sup>123</sup> At no point is any sum of money that has been deposited with an FCM insured or protected in a manner comparable to the regime provided by the SIPA.

The CFTC considered such a program in the wake of several high-profile FCM insolvencies during the 1980's, but ultimately concluded that it was not cost-effective.<sup>124</sup> The NFA concurred in that determination, but noted that were it to be created, the compensation regime under such a program would have to focus on facilitating the transfer, rather than liquidation, of open positions in order to avoid involuntarily exposing customers to unfavorable market prices.<sup>125</sup> This is the same priority expressed in the FCM bankruptcy provisions,<sup>126</sup> and both are rooted in the concern that FCM bankruptcies should not be allowed to disrupt the market, harm investor confidence, or interfere with bona fide hedging activities.<sup>127</sup>

Precisely because of these priorities, SIPA protections should be extended to cover the cost of transferring open positions in futures accounts, up to a pre-determined amount. The current ad-hoc process of determining how much, or how little, money is available on a pro rata basis

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117. 7 U.S.C.A. § 6d(a)(2) (2007).

118. 7 U.S.C.A. § 6d(a)(2).

119. *Id.*

120. *In re Griffin Trading Co.*, 245 B.R. 291, 302 (Bankr. N.D. Ill. 2000).

121. 17 C.F.R. § 190.08(c) (2007).

122. 17 C.F.R. § 190.06(e)(2). But note that customers do have a right to contact the trustee and, upon payment of any additional funds required to meet margin, transfer the full balance of their open positions to a solvent FCM. 17 C.F.R. § 190.02(g)(3).

123. *Griffin*, 245 B.R. at 301.

124. Andrea M. Corcoran & Susan C. Ervin, *Maintenance of Market Strategies in Futures Broker Insolvencies: Futures Position Transfers From Troubled Firms*, 44 WASH. & LEE L. REV. 849, 869-70 (1987).

125. *Id.* at 870.

126. *See supra* note 122.

127. Corcoran & Ervin, *supra* note 124, at 884-85.

from the insolvent FCM to fund the transfer of customers' open positions is simply too complicated and too uncertain to provide adequate protection for either customers or the marketplace.<sup>128</sup> Without guarantees of sufficient funding, such as those provided by a SIPA-like program, other FCMs may not be willing to receive open positions from customers of the bankrupt FCM,<sup>129</sup> resulting in considerable losses to everyone involved.<sup>130</sup> A harmonized program would compensate customers for losses in securities in the manner currently provided for by the SIPA,<sup>131</sup> and continue to provide reliable short-term funding for the transfer of open positions in futures on an ad-hoc basis, as the FCM bankruptcy rules currently do.<sup>132</sup>

#### D. INSIDER TRADING

The Securities Exchange Act makes it unlawful “[t]o use or employ, in connection with the purchase or sale of any security . . . any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe.”<sup>133</sup> This broad provision is the basis for Rule 10b-5, which prohibits “engag[ing] in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.”<sup>134</sup> These provisions ban the practice of insider trading, which courts have defined as either “trad[ing] in the securities of [a] corporation on the basis of material, nonpublic information,”<sup>135</sup> or “misappropriat[ing] confidential information for securities trading purposes, in breach of a duty owed to the source of the information.”<sup>136</sup> The former definition, known as the classical theory, is aimed at “corporate insiders” such as directors, officers, lawyers, or bankers, and is based on the notion that they have a fiduciary duty to shareholders of the corporation not to trade for their own

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128. *See id.* at 902–03.

129. *Id.* at 906–07.

130. Just such a situation occurred when an FCM became insolvent during the 1980’s. *See id.* at 913.

That case reflected that even full compliance with the Commodity Exchange Act’s stringent segregation requirements could not assure the firm’s customers against loss and that once such losses had occurred, no formal governmental or self-regulatory program was in place to restore such losses. Moreover, the positions of the firm’s customers were liquidated without any serious attempt to transfer them, reflecting the current absence of any mechanism to replenish available segregated funds to provide margin sufficient to permit transfers.

*Id.*

131. *See supra* notes 115–16.

132. *See supra* note 122.

133. 15 U.S.C.A. § 78j(b) (2006).

134. 17 C.F.R. § 240.10b-5 (2007).

135. *U.S. v. O’Hagan*, 521 U.S. 642, 651–52 (1997).

136. *Id.* at 652.



personal benefit on the basis of inside information.<sup>137</sup> The latter definition, known as the misappropriation theory, is aimed at “corporate outsiders” who happen to come across inside information, and it is based on the notion that their fiduciary duty is to the source of that information, whom they defraud if they trade on that information without disclosing their intentions.<sup>138</sup> Whether by insider or outsider, the clear intent is to prohibit traders from profiting off the use of non-public information, as this is an effective way of “insur[ing] the maintenance of fair and honest markets.”<sup>139</sup>

The Commodity Exchange Act, by comparison, generally does not prohibit insider trading. This is largely because one of the basic functions of the futures markets is to allow hedgers, based on knowledge of their own positions, to shift the risk of their commodity positions.<sup>140</sup> The other basic function of the futures markets is price discovery, whereby all market information known to both hedgers and speculators is reflected by the market price of any given contract.<sup>141</sup> Consequently, CEA provisions against the use of material non-public information target only CFTC regulatory personnel<sup>142</sup> and contract market or futures industry compliance personnel.<sup>143</sup> These persons are prohibited from trading with material non-public information,<sup>144</sup> and from giving it to others for the purpose of trading.<sup>145</sup> Recipients who know the source of such information are likewise prohibited from trading with it.<sup>146</sup> The concern of the Commodity Exchange Act, generally speaking, is not so much that traders will profit through the use of non-public information,<sup>147</sup> but that someone involved in market regulation will use their position to gain unfair access to information about

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137. *Chiarella v. U.S.*, 445 U.S. 222, 227 (1980).

138. *O'Hagan*, 521 U.S. at 654–55 (suggesting that this theory of liability has a rather significant loophole, however, because “if the fiduciary discloses to the source that he plans to trade on the nonpublic information, there is no ‘deceptive device’ and thus no § 10(b) violation—although the fiduciary-turned-trader may remain liable under state law for breach of a duty of loyalty.”).

139. 15 U.S.C.A. § 78b (2006).

140. Jerry W. Markham, ‘*Front-Running*’—*Insider Trading Under the Commodity Exchange Act*, 38 CATH. U. L. REV. 69, 105 n.221 (1988).

141. See Chester S. Spatt, Chief Economist and Dir., Office of Econ. Analysis, SEC, Keynote Address at Wilton Park Conference on Capital Flows and the Safety of Markets: Volatility, Price Discovery, and Markets (Nov. 10, 2006) (transcript available at <http://www.sec.gov/news/speech/2006/spch111006css.htm>) (describing generally the price discovery process).

142. 7 U.S.C.A. § 13(c), (d) (2007).

143. 7 U.S.C.A. § 13(f)(1)–(2).

144. 7 U.S.C.A. § 13(f)(1).

145. 7 U.S.C.A. § 13(d)(1), (f)(1).

146. 7 U.S.C.A. § 13(d)(2), (f)(2).

147. *But see* 7 U.S.C.A. § 6j (prohibiting the practice of “dual-trading,” which is a kind of insider trading performed by FCMs who, upon receipt of a customer order, place their own trade before that of the customer in such a way as to profit from what is to come).

“changes in the futures trading environment that might occur through the exercise of an exchange’s emergency authority.”<sup>148</sup>

This disparity in insider-trading regulation represents a significant challenge for the harmonization of securities and futures markets. On the one hand, research suggests that the strict insider trading regime of the securities industry has had numerous positive effects on securities markets, including more informative pricing and greater liquidity.<sup>149</sup> On the other hand, the infusion of heretofore non-public information into the futures markets, in conjunction with bona fide hedging activities, is considered one of their fundamental features.<sup>150</sup> More concretely, applying the securities industry prohibition uniformly onto the futures industry would simply be impracticable, as the rubric of fraud and the duties it implicates in order to analyze insider trading does not exist in the futures industry.<sup>151</sup> It would likewise be impossible to apply the futures industry’s *laissez faire* “insider trading” regime to the securities industry, as it would eviscerate all protection against the concern that corporate insiders will use non-public information to trade in the securities of their own corporations to the disadvantage of outsiders.<sup>152</sup>

At the outset, a harmonized insider trading rule should not be premised on the breach of a fiduciary duty, as the concept has no application to the futures markets<sup>153</sup> and is already quite strained when applied to some securities transactions.<sup>154</sup> One potential alternative might be to draw from the proposal of Professor Jerry Markham, originally aimed only at the futures industry in response to the stock market crash of 1987, to distinguish between the use of inside information for bona fide hedging and the use of inside information for the purpose of gaining an unfair advantage

148. Markham, *supra* note 140, at 110.

149. Laura Nyantung Beny, *Do Insider Trading Laws Matter? Some Preliminary Comparative Evidence*, 7 AM. L. & ECON. REV. 144, 174 (2005).

150. See Markham, *supra* note 140, at 93–94.

151. Nina Swift Goodman, *Trading in Commodity Futures Using Non-Public Information*, 73 GEO. L. J. 127, 144–51 (1984).

152. Recall that the futures industry only prevents market regulators from trading with certain material non-public information. *Supra* notes 142–44.

153. Goodman, *supra* note 151, at 144–46 (explaining that there are no “insiders” on a futures contract like there are for a corporation’s stock, and there can be no misappropriation from the source of information because it does not defraud him to trade with the knowledge he imparts).

154. Kimberly D. Krawiec, *Fairness, Efficiency, and Insider Trading: Deconstructing the Coin of the Realm in the Information Age*, 95 NW. U. L. REV. 443, 475–76 (2001) Krawiec illustrates the absurdity of depending on breaches of fiduciary duty by noting that

defenders of the current system of insider trading regulation have failed to explain why trading on information overheard in conversations, gleaned from documents in a briefcase stolen from a stranger, entrusted to a hairdresser by one of her clients or to a husband by his wife are [not prohibited], while trading on information gained in a tip from an insider, from information stolen from one’s employer or father, or entrusted to a physician by his patient are [prohibited].

*Id.*

in anticipation of others' market-moving actions.<sup>155</sup> This approach focuses on preventing unfair advantage, as insider trading prohibitions are meant to do in the first place.<sup>156</sup> This approach would also comport well with the principles-based regulation that has been so effective for the CFTC,<sup>157</sup> as it would provide the flexibility necessary to distinguish between acceptable disparities of market information and genuinely unfair practices,<sup>158</sup> while still allowing for bona fide hedging transactions.

#### E. BROKER-DEALER AND FCM REGISTRATION AND OPERATION

Broker-Dealers make public access to securities markets possible, as their purpose is to “effect securities transactions, provide investment advice, take custody of securities and funds, extend credit, and even exercise investment discretion.”<sup>159</sup> Although commonly lumped together by both lay persons and professionals, “broker” and “dealer” are technically two different classifications. A “broker” is “any person engaged in the business of effecting transactions in securities for the account of others,”<sup>160</sup> while a “dealer” is “any person engaged in the business of buying and selling securities for such person’s own account through a broker or otherwise.”<sup>161</sup> Both definitions exclude banks,<sup>162</sup> and “dealer” does not encompass a person who “buys or sells for [their] own account . . . but not as part of a regular business.”<sup>163</sup> Both definitions do, however, include persons who conduct business solely on the floor of a securities exchange.<sup>164</sup> Despite this technical difference, most firms are both brokers and dealers and there is virtually no difference in the substantive regulation of the two, particularly as the determination of who constitutes a broker or dealer is a fact-based inquiry that involves many factors common to both.<sup>165</sup> As a result, they are commonly referred to jointly as “broker-dealers.”

All broker-dealers, with the exception of those doing purely intrastate business, are required to register with the SEC.<sup>166</sup> Employees of broker-

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155. Markham, *supra* note 140, at 123–24.

156. *See* 15 U.S.C.A. § 78b (2006).

157. Bart Chilton, Comm’r, CFTC, Remarks Before the Futures Industry Association, Law and Compliance Luncheon (Nov. 13, 2007).

158. *U.S. v. O’Hagan*, 521 U.S. 642, 658–59 (1997) (distinguishing between material non-public information that is gained through skill and research and that which is gained through misappropriation from an otherwise inside source).

159. David A. Lipton, *A Primer on Broker–Dealer Registration*, 36 CATH. U. L. REV. 899, 899 (1987).

160. 15 U.S.C.A. § 78c(a)(4) (2006).

161. 15 U.S.C.A. § 78c(a)(5).

162. *See* 15 U.S.C.A. § 78c(a)(4)(B), (5)(C).

163. 15 U.S.C.A. § 78c(a)(5)(B).

164. Lipton, *supra* note 159, at 905.

165. *See generally id.* at 908–43 (providing a detailed examination of the various factors that go into this determination).

166. 15 U.S.C.A. § 78o(a)(1).

dealers are considered “registered representatives”<sup>167</sup> and do not have to register with the SEC,<sup>168</sup> but they are required to register with the NASD.<sup>169</sup> Upon registration, broker-dealers must adhere to a minimum net capital requirement based on one of two standards:<sup>170</sup> Either they may not allow their aggregate indebtedness to exceed 800% of their net capital, or they may not allow their net capital to be less than \$250,000 or 2% of their calculated Reserve Requirement, whichever is greater.<sup>171</sup>

The futures industry’s functional equivalent of the broker-dealer is the FCM, which is defined as an

individual, association, partnership, corporation, or trust that is engaged in soliciting or in accepting orders for the purchase of any commodity for future delivery . . . and in connection with such solicitation or acceptance of orders, accepts any money, securities or property . . . to margin, guarantee or secure and trades or contracts.<sup>172</sup>

In addition, the futures industry recognizes “introducing brokers” (IBs), which are treated like FCMs in almost every respect except that they cannot accept any “money, securities, or property . . . to margin, guarantee, or secure any trades or contracts.”<sup>173</sup> Every FCM and IB must be registered with the CFTC.<sup>174</sup> In contrast to the employees of broker-dealers, however, the employees of FCMs or IBs must also register with the CFTC as “associated persons.”<sup>175</sup> Moreover, those who confine their activities to the trading floor and trade for their own accounts, or for the accounts of others, are subject to a separate registration regime as either “floor traders” or “floor brokers.”<sup>176</sup> Each FCM must meet certain minimum financial requirements<sup>177</sup> by maintaining net capital in excess of the greater of either \$250,000,<sup>178</sup> or 8% of the total risk margin of their customer accounts plus 4% of the total risk margin of their non-customer accounts.<sup>179</sup> IBs are

167. Lipton, *supra* note 159, at 909.

168. *But see* 15 U.S.C.A. § 78o(b)(1) (requiring that any person “associated with [a] broker or dealer” be named on the broker–dealer’s registration. Such associated persons are defined in 15 U.S.C.A. § 78c(a)(18) to include partners, managers, officers, and all employees who are not of a ministerial or clerical capacity).

169. 17 C.F.R. § 240.15b7-1 (2007); *accord* NASD Rule 1030, *available at* [http://finra.complinet.com/finra/display/display\\_viewall.html?rbid=1189&element\\_id=1159000445](http://finra.complinet.com/finra/display/display_viewall.html?rbid=1189&element_id=1159000445) (last visited Oct. 26, 2007).

170. 17 C.F.R. § 240.15b2-2.

171. 17 C.F.R. § 240.15c3-1(a)(1) (note that aggregate indebtedness may not exceed 1500% of net capital during the first 12 months of operation).

172. 7 U.S.C.A. § 1a(20) (2007).

173. 7 U.S.C.A. § 1a(23).

174. 7 U.S.C.A. § 6d.

175. 7 U.S.C.A. § 6k(1).

176. 7 U.S.C.A. § 1a(16)–(17). Note, however, that both are subject to registration. 7 U.S.C.A. § 6e.

177. 7 U.S.C.A. § 6f(b).

178. 17 C.F.R. § 1.17(a)(1)(i)(A) (2007).

179. 17 C.F.R. § 1.17(a)(1)(i)(B).

subject to less stringent financial requirements, as they must only maintain a minimum net capital of at least \$30,000,<sup>180</sup> or may choose to enter into an agreement with an FCM to guarantee its financial obligations.<sup>181</sup>

In addition to the initial requirements of registration, both broker-dealers and FCMs<sup>182</sup> are continually subject to a wide variety of reporting and recordkeeping requirements.<sup>183</sup> The sheer number of different records and reports they must perform makes a rigorous examination of all of them impractical for the purposes of this note, but for both industries they generally include detailed records of the firm's finances, precise records of customer account balances and activities and regular disclosure to both customer and regulators.<sup>184</sup> In addition, broker-dealers and FCMs must keep detailed records and make reports to regulators with regard to their risk-assessment regimes.<sup>185</sup> While there are minor differences in the form and timing of these requirements, they are for the most part very similar. The most significant difference is the settlement cycle by which customer accounts reflect changes in positions. FCMs must mark to market their customers' accounts on a daily basis,<sup>186</sup> whereas broker dealers have three days to do so.<sup>187</sup>

Very little imagination is required to harmonize these regulations. Indeed, they are already quite similar. Combining brokers, dealers and FCMs into a single entity able to conduct business in both securities and futures might result in an entity defined as:

Any individual, association, partnership, corporation, or trust that is engaged in soliciting or in (1) accepting orders for the purchase of any commodity for future delivery; (2) effecting transactions in securities for the account of others; or (3) the business of buying and selling securities for such person's own account as part of a regular business; and in connection with such activities, accepts any money, securities or property to margin, guarantee or secure and trades or contracts.<sup>188</sup>

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180. 17 C.F.R. § 1.17(a)(1)(iii)(A).

181. 17 C.F.R. § 1.10(j).

182. Hereinafter, any reference to FCMs also encompasses IBs.

183. *See generally* 15 U.S.C.A. § 78q(a)(1) (2006); 7 U.S.C.A. § 6g (2007) (authorizing recordkeeping and reporting for both industries, respectively).

184. *See generally* 17 C.F.R. § 240.17a-2-5; §§ 1.10, .18, .31-.37 (regarding securities and futures, respectively).

185. *See* 17 C.F.R. §§ 240.17h-1T, -2T; § 1.14-5.

186. 17 C.F.R. § 1.32. This process results in FCMs paying any excess or collecting any shortfall in their customers' margin requirements on a daily basis. NAT'L FUTURES ASS'N, *supra* note 73, at 27-28.

187. 17 C.F.R. § 240.15c6-1.

188. This is a simple combination of the statutory definitions currently in place for brokers, dealers, and FCMs. *See supra* notes 160, 161 and 172 and accompanying text.

Whether to maintain an alternative classification for IBs,<sup>189</sup> and how to classify professionals whose activities are confined solely to the trading floor,<sup>190</sup> are policy questions that scholars have not yet debated.

Other areas of these regulations could be harmonized in an equally straightforward manner. Harmonizing the minimum financial requirements for the combined broker-dealer-FCM entity would require a more rigorous econometric analysis of their intended purpose than is feasible here, but given the similarity between current regulations, a minimum of \$250,000 appears to be a reasonable starting point for such a discussion.<sup>191</sup> Likewise, the similarity between reporting and record-keeping requirements<sup>192</sup> should make harmonization relatively simple. One point where harmonization will require genuine change is in settlement periods, which might best be set at a daily mark to market in order to preserve the integrity it currently provides for futures contracts,<sup>193</sup> and extend that protection to securities.<sup>194</sup>

## V. CONCLUSION

Achieving a harmonized regulatory environment for securities and futures will not be an easy task,<sup>195</sup> but it should be on the agenda of any policymaker who wishes for the United States' financial markets to remain competitive.<sup>196</sup> Indeed, as this note goes to press the Treasury Secretary has just released the Department's Blueprint for a Modernized Financial

189. There is no analogue to the IB in the securities industry.

190. *See supra* notes 164 and 176 (Recall that SEC rules require these professionals to be registered as broker-dealers, while CFTC rules provide them with a separate regulatory framework).

191. *See supra* notes 171 and 178 (wherein both broker-dealers and FCMS are currently able to satisfy minimum financial requirements with \$250,000).

192. *See supra* note 184.

193. Daily mark-to-market settlement, a feature of futures markets, increases liquidity by allowing traders to realize their gains on a daily basis, and improves market stability by forcing traders to realize their losses on a daily basis as well. This is in contrast to the three-day settlement period of securities markets, which forces traders to wait several days before realizing gains, and may allow losses to accumulate for several days before they must be accounted for. *See Securities Transaction Settlement*, Release No. 8398, 2004 WL 482332, at \*11 (Mar. 11, 2004).

194. The SEC recently noted that a shorter settlement cycle in the securities markets would improve their efficiency and reduce their risks. *Id.* at \*12.

Shortening the settlement cycle to T+1, for example, also would synchronize the settlement of corporate and derivative securities and have liquidity benefits. By reducing the lag between the settlement of derivatives and government securities and the settlement of equity and corporate securities, investors that participate in both markets would be able to reduce their financing costs and obtain the proceeds of their securities transactions on a timelier basis.

*Id.*

195. *See supra* Part II (detailing the failure of the Markets and Trading Reform Act. Note, however, that it was a relatively un-ambitious regulatory reshuffling, as opposed to wholesale reform).

196. *See DeWaal, supra* note 37; MCKINSEY & CO., *supra* note 41.

Regulatory Structure,<sup>197</sup> which in part calls for precisely the kinds of harmonization detailed here.<sup>198</sup> Although the Blueprint has been criticized in the popular press as nothing more than a “rearrangement of the boxes on the org chart,”<sup>199</sup> in the area of harmonizing securities and futures regulations it prescribes more than mere bureaucratic reshuffling,<sup>200</sup> and has called for a joint CFTC-SEC task force to examine the matter substantively and in depth.<sup>201</sup> This note’s recommendations should provide a useful starting point for some of that group’s work.

The Treasury Blueprint is a far more comprehensive and far-ranging examination of financial regulatory harmonization,<sup>202</sup> but the discrete areas of securities and futures regulation that have been examined in this note are important pieces of the puzzle. Harmonizing margin requirements at a level close to that of current futures margins can sufficiently protect markets from excessive risk and provide much-needed liquidity.<sup>203</sup> Identical suitability rules are a sensible way to protect investors from unscrupulous or irresponsible advice, regardless of the particular products being recommended.<sup>204</sup> The extension of SIPA-like protections to all accounts would enhance investor confidence and stabilize the marketplace when a broker-dealer or FCM goes under.<sup>205</sup> A well-crafted insider trading prohibition that targets only the unfair use of inside information will provide security and promote fairness across markets, while still allowing legitimate hedging to proceed.<sup>206</sup> And harmonized broker-dealer/FCM registration requirements will allow market professionals to more efficiently offer a wide variety of diverse and innovative financial products.<sup>207</sup> All of these are necessary regulatory adjustments that must be made in order for U.S. markets to remain competitive and stable as securities and futures continue to converge in the twenty-first century.

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197. DEP’T OF THE TREASURY, BLUEPRINT FOR A MODERNIZED FINANCIAL REGULATORY STRUCTURE (2008).

198. *Id.* at 116.

199. Paul Krugman, *The Dilbert Strategy*, N.Y. TIMES, Mar. 31, 2008, at A21.

200. *See supra* Part II (noting the failure of prior attempts to reshuffle bureaucracy).

201. DEP’T OF THE TREASURY, *supra* note 197, at 118.

202. *See id.* at 5–21.

203. *See supra* Part IV.A.

204. *See supra* Part IV.B.

205. *See supra* Part IV.C.

206. *See supra* Part IV.D.

207. *See supra* Part IV.E.

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