SEC and CFTC Recommend Extensive Changes to "Harmonize" Their Regulatory Programs

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October 22, 2009 - A Joint Report of the SEC and the CFTC on Harmonization of Regulation (the "Harmonization Report") was issued on Friday of last week. The Harmonization Report, which can be found here, is of considerable importance not only because it makes significant recommendations for legislative action, but also because it recommends numerous regulatory changes that the SEC and CFTC can make, and probably will pursue, without Congressional action.

Background: Treasury Proposals

Various proposals have been made to merge the SEC and CFTC, including a proposal published by the U.S. Treasury Department in March 2008. Among other things, such proposals have reflected a recognition that the SEC and CFTC apply regulatory approaches that are in many respects quite different, notwithstanding that the instruments and activities that they regulate are often quite similar. For example, the SEC applies more of a "rules-based" approach in regulating *securities* clearing agencies and exchanges, whereas the CFTC applies more of a "principles-based" approach to regulating *futures* clearing organizations and exchanges. Accordingly, the Treasury's 2008 proposal contemplated that the relevant statutes and regulations under which the SEC and CFTC currently operate would be "harmonized," so that more comparable regulatory treatment would apply to similar instruments and activities.

For some time, however, it has been apparent that the proposal to merge the CFTC and SEC is unlikely to proceed in the near future. Nevertheless, proposals to "harmonize" SEC/CFTC regulation have continued to be very much under consideration.

In particular, the Treasury Department again addressed this issue in its June 17, 2009 "White Paper" that outlined the Obama administration's then-proposed reforms for financial regulatory reform. Although the White Paper did not recommend a merger of the SEC and CFTC, it did recommend a thoroughgoing harmonization and rationalization of the regulatory regimes administered by both agencies. In particular, the White Paper recommended that the CFTC and the SEC, by September 30, 2009, provide Congress with a report identifying all differences in those agencies' regulation of similar products and either justifying those differences or recommending changes to eliminate the differences. If the SEC and CFTC could not agree by that date, the White Paper recommended that the matter be referred to the Financial Services Oversight Council (which the administration's proposals also would create), which would be required to report its recommendations to Congress within six months after the Council's formation.

The Harmonization Report has been motivated in part by the White Paper's forceful suggestion that the SEC and CFTC harmonize their regulatory programs and reconcile their differences.

Overview of the Harmonization Report

The Harmonization Report reviews and analyzes the current statutory and regulatory structure for the SEC and CFTC in the following areas:

- Product listing and approval;
- Exchange/clearinghouse rules;
- Risk-based portfolio margining and bankruptcy/insolvency regimes;
- Linked national market and common clearing versus separate markets and exchange-directed clearing;
- Price manipulation and insider trading;
- Customer protection standards applicable to financial advisers;
- Regulatory compliance by dual registrants; and
- Cross-border regulatory matters.

The Harmonization Report makes twenty recommendations for strengthening the agencies' oversight and enforcement activities, enhancing investor and customer protection, rendering compliance more efficient, and improving coordination and cooperation between the agencies. We address below some of the report's recommendations that have particular relevance for certain of our core client groups, including investment advisers, investment funds, and insurance companies.

Most of the report's recommendations are general in nature. That is, the report recommends that the Congress, SEC, or CFTC take action to accomplish stated objectives, but generally does not recommend the specific content of the legislative or regulatory provisions that should be enacted to accomplish those objectives. The devil is very much in the details, of course, and considerable additional work remains before most of the recommendations could be acted upon.

Risk-Based Portfolio Margining

Risk-based portfolio margining is a method for calculating margin requirements under which the amount of margin required for holding one position can be reduced if another position simultaneously held by the customer offsets the risk posed by the first position. Currently, certain statutory and regulatory requirements in the U.S. limit the ability to engage in such risk-based portfolio margining where one of the positions is a security product and the other position is a futures product. This can increase the capital requirements for broker-dealers and futures commission merchants, as well as increase investors' costs in posting margin.

These disadvantages of the current system in the U.S. are not present in certain foreign jurisdictions that extensively permit risk-based portfolio margining across securities and futures products. Thus, the current system in the U.S. suffers from the additional disadvantage of tending to drive transactions into overseas markets.

The Harmonization Report recognizes these problems and recommends legislative and regulatory changes to address them, with due consideration to all other regulatory objectives. Any such reforms would very likely afford benefits to many investors who use both futures and securities products, including mutual funds, private investment funds, other clients of investment advisers, and insurance companies.

Uniform Fiduciary Standard for Those Providing Investment Advisory Services

The Harmonization Report recommends legislation that would impose a "uniform fiduciary duty" on persons who provide similar investment advisory services regarding futures or securities. This uniform fiduciary duty would apply to persons regulated by either or both of the SEC and CFTC, including investment advisers, broker-dealers, commodity trading advisers and futures commission merchants.

Although the fiduciary duty that would be imposed is described as "uniform," the report nevertheless recognizes that the behavior of the regulated person "acting in the best interest of its client may vary based on facts and circumstances, including the nature of the customer relationship and the services provided." The Harmonization Report does not attempt to sort out the substance of how the fiduciary duty should be defined in different circumstances. This, of course, has been a "hot issue" for some time in the securities arena, with many investment advisory firms arguing that broker-dealers should be subject to a fiduciary duty, while at the same time fearing that any specific definition of fiduciary duty would be likely to "water down" the duty too much in the broker-dealer context. Many broker-dealers, on the other hand, fear that imposition of a fiduciary duty on them would prove fundamentally incompatible with their business model.

To add CFTC-regulated entities into the mix further complicates the problem of achieving "uniformity" without jeopardizing legitimate differences in business model that may even provide benefits to investors in many cases. For example, the "suitability" requirements that apply to SEC-regulated broker-dealers at least bear some similarity to the fiduciary duty that SEC-regulated investment advisers have when making recommendations. By contrast, futures commission merchants generally are not subject to the same type of transaction-by-transaction suitability requirements to which SEC-regulated broker-dealers are subject.

The Harmonization Report's approach to the development of a uniform fiduciary standard is similar to the approach taken by various legislative initiatives that are already working their way through Congress. For example, a draft "Investor Protection Act of 2009" was released on October 1, 2009 by Representative Paul Kanjorski, Chairman of the House Financial Services Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises. Rep. Kanjorski's draft (which can be found here*)* would mandate that the SEC require any broker, dealer, or investment adviser providing investment advice to retail customers (and such other customers as the SEC may by rule provide) must act in the best interest of the customer without regard to the financial or other interest of the person rendering the advice. The draft legislation, however, attempts to preserve commission-based compensation, by providing that receipt of such compensation would not constitute a violation of this duty by a broker or dealer. Also, Rep. Kanjorski's draft does not embrace CFTC-regulated entities.

Alignment of Certain Private Fund Regulatory Requirements

Many private investment funds trade both securities and futures, and their advisers may be subject to regulation as both registered investment advisers and commodity trading advisers/pool operators. This can cause significant problems. For example, the SEC and the CFTC take very different positions on the question of performance disclosure, with one agency sometimes even requiring disclosure of a type that the other agency will not permit.

The Harmonization Report recommends that the SEC and CFTC review their requirements applicable to investment advisers and commodity trading advisors/commodity pool operators with respect to private funds to eliminate, as appropriate, any inconsistent or conflicting provisions regarding:

- The use of performance records;
- Requirements applicable to investor reports (including financial statements); and
- Recordkeeping requirements.

Although these reforms would doubtless be of some use to advisers of many private funds, some have recommended that the SEC and CFTC make even more efforts in this area. For example, Richard H. Baker, President of the Managed Funds Association, made an appearance as part of joint meetings that the SEC and CFTC held on September 2 and 3, 2009 to explore the subject of harmonizing and reconciling SEC and CFTC regulation. Mr. Baker recommended that:

- The SEC and CFTC conduct a general re-examination of their compliance requirements applicable to advisers or sponsors of private funds or pools that trade both securities and commodities;
- The requirements should be revised so that such regulated firms could maintain a single compliance manual with consistent, if not uniform, policies and procedures; and
- The SEC and CFTC should examine and simplify, coordinate and rationalize the current myriad of different and confusing standards for investor "sophistication" that they currently administer (*i.e.,* such standards as "accredited investor," "qualified client," "qualified purchaser," "qualified institutional buyer," "qualified eligible person," and "eligible contract participant").

The Harmonization Report does not specifically adopt any of these recommendations.

Expand CFTC Conflict of Interest Prevention Authority

The Harmonization Report recommends that legislation be enacted to authorize the CFTC to require futures commission merchants and introducing brokers to implement conflict of interest procedures that would separate the activities of firm personnel engaged in research or analysis of commodity prices from those involved in trading or clearing activities. The report refers to the Obama administration's proposed "Over-the-Counter Derivatives Markets Act of 2009" (which can be found here) as containing such provisions. Such provisions are also contained in H.R. 3795 (which can be found here), which is a version of the Over-the-Counter Derivatives Markets Act of 2009 that was reported to the House of Representatives by vote of the House Financial Services Committee on October 15, 2009. The enhanced conflict of interest procedures contemplated by this legislation would be similar to procedures that SEC-registered broker-dealers are already required to maintain.

Enhanced Whistleblower Protections

Legislation is currently working its way through Congress that would vastly expand the circumstances under which the SEC could give very substantial monetary rewards to "whistleblowers" who provide information to the SEC that results in a monetary sanction against an alleged violator of the securities laws. The Harmonization Report recommends that this type of legislation be passed and that similar legislation be passed with respect to the CFTC.

While this type of whistleblower legislation can, of course, have some benefits in enhancing the effectiveness of governmental enforcement activities, it can also have numerous unintended negative consequences. Our Task Force on Modernizing Financial Services Regulation recently issued an Alert (which can be found here*)* that analyzed these subjects in the context of the proposed SEC whistleblower legislation.

Registration of Investment Advisers and Commodity Trading Advisers

The Investment Advisers Act of 1940 currently exempts from its registration requirement any investment adviser that (i) is registered with the CFTC as a Commodity trading adviser, (ii) is not engaged primarily in rendering securities advice, and (iii) does not advise a registered investment company or business development company. There is a similar exemption in the Commodity Exchange Act for persons rendering commodity advice, but not as their primary business, who are registered with the SEC as investment advisers. The aforementioned exemption from investment adviser registration is proposed to be repealed for any adviser to a hedge fund or other private investment company. This proposed repeal appears, for example, in a draft "Private Fund Investment Advisers Registration Act of 2009" that Rep. Kanjorski released on October 1, 2009. That draft legislation, which can be found here, evolved from the draft act bearing the same name that the Obama administration published on July 15, 2009 and that contained the same repeal.

In his above-mentioned testimony at a joint SEC/CFTC meeting, Richard H. Baker, on behalf of the Managed Funds Association, argued against the proposal to make the commodity trading adviser exemption from investment adviser registration unavailable to any adviser to a private investment company. Rather, Mr. Baker urged that advisers generally should continue to be subject to the CFTC's or the SEC's registration framework depending on whether they are primarily engaged in the business of advising on the value or advisability of trading in (i) futures or (ii) securities. Baker recommended that advisers who are engaged equally or largely in advising on *both* futures and securities should be subject to both CFTC and SEC registration. Baker further recommended that:

- The CFTC and SEC consider harmonizing their registration procedures to avoid inconsistencies or duplicate filings;
- The National Futures Association's ("NFA") registration database and the Investment Adviser Registration Depository should be merged or coordinated; and
- The CFTC and SEC should engage in joint or coordinated examinations of registered advisers who engage in both futures and securities advisory activities.

The Harmonization Report does not specifically adopt any of these recommendations.

Regulation of Public Commodity Pools

On behalf of the Managed Funds Association, Mr. Baker also noted at the joint SEC/CFTC meeting that public commodity pools, and the offer and sale of interests therein, are subject to regulation under the Securities Act of 1933, the Securities Exchange Act of 1934, the Commodity Exchange Act, and state blue sky laws. Thus, such pools are subject to regulation by the SEC, FINRA, CFTC, NFA, and state regulators. Accordingly, Mr. Baker recommended coordination among all of these regulators to streamline and add regulatory consistency to the oversight process. Again, however, the Harmonization Report does not specifically adopt this recommendation.

Other Initiatives Involving Cooperation Between SEC and CFTC

In addition to the specific recommendations discussed in this Alert, the Harmonization Report recommends many other undertakings (both narrow and broad) in which the SEC and CFTC will coordinate and cooperate. This pattern of increased SEC/CFTC coordination and cooperation is also being expressed and reinforced in various other ongoing initiatives in connection with regulatory reform.

For example, the SEC and the CFTC have already been cooperating extensively with each other (as well as with various other governmental and non-governmental entities) in connection with developing new or enhanced mechanisms for trading over-the-counter derivatives (including credit default swaps) and regulating such trading and certain persons who engage in such trading. The previously-mentioned Over-the-Counter Derivatives Markets Act of 2009 would take major additional steps to further these objectives. Among the many notable features of this proposed legislation is the high degree of cooperation and coordination that it mandates between the SEC and the CFTC. In numerous instances, for example, the Over-the-Counter Derivatives Markets Act of 2009 would mandate that the SEC and CFTC take joint action (for example, in adopting certain rules or other positions) and that such action be uniform. The legislation also mandates that the SEC and CFTC give similar treatment to products that are functionally or economically similar.

Moreover, under the Over-the-Counter Derivatives Markets Act of 2009, if the SEC and the CFTC fail in a timely manner to jointly prescribe uniform rules as provided in the legislation, the Secretary of the Treasury would be authorized and directed to adopt such rules and regulations. The Secretary, however, would consult with the SEC and CFTC in adopting such rules, which would remain in force only until such time as the SEC and CFTC act jointly.

The above-mentioned Private Fund Investment Advisers Registration Act of 2009 likewise calls for cooperation and coordination between the two agencies. Specifically, that legislation would require that, within six months of enactment, the SEC and CFTC jointly promulgate rules to establish the form and content of certain reports that are required to be filed with the SEC and the CFTC by investment advisers that are registered with both agencies.

The bottom line is that, although the SEC and CFTC will not soon be merged, the legislative and regulatory tide seems to be running strongly in favor of the two agencies doing everything they can to speak with one voice, to the extent practicable. Conceivably, by some not-too-distant time, the two agencies may in many respects function as if they were merely divisions of single agency.

For additional information:

Jorden Burt has formed a special Task Force to monitor these proposals and other proposals relating to reform of financial services regulation. To obtain additional information about particular proposals that might have an impact on the insurance or reinsurance industries, you may contact Roland Goss (rcg@jordenusa.com or (202) 965-8148). To obtain additional information about particular proposals that might have an impact on the investment adviser and fund industries you may contact Tom Lauerman (tcl@jordenusa.com or (202) 965-8156). Or you may contact any of Jorden Burt's other regulatory attorneys.