Liabilities and Commitments, Release Nos. 33-8144, 34-46767, 2002 SEC LEXIS 2810 (Nov. 4, 2002).

9 Disclosure in Management's Discussion and Analysis about Off-Balance Sheet Arrangements and Aggregate Contractual Obligations, Release Nos. 33-8182, 34-47264, 2003 SEC LEXIS 227 (Jan. 28, 2003).

10 The SEC did not conclude that securities prices would not reflect this information because some investors would be overwhelmed. In fact, such information is precisely the type of information that would be most useful to sophisticated investors and analysts, who are the target audience for these kinds of disclosures, because of the view that their activities will be reflected in securities prices. Few individual investors can read or understand the basics of an average annual report, much less the complexities of contingent disclosures related to derivatives.

11 *See* Chevron, U.S.A., Inc. v. NRDC, 467 U.S. 837 (1984); *see also* FDA v. Brown & Williamson Tobacco Corp., 529 U.S. 120 (2000) (applying *Chevron* analysis in assessing whether Congress granted the Federal Food and Drug Administration jurisdiction to regulate tobacco products).

12 Chevon, 467 U.S. at 842-43.

13 Id. at 843.

14 *See, e.g.,* Daniel B. Rodriguez, The Positive Political Dimensions of Regulatory Reform, 72 Wash. U. L. Q. 1, 133-38 (1994) (assessing arguments regarding relevant expertise of legislatures, agencies, and the judiciary).

15 The issue is conflated by two unique problems. First, "may" includes within its definition the meaning specifically encompassed by the term ultimately used in the regulation. Second, the standard for judging the agency interpretation—whether it was reasonable—is also subsumed within the words in the regulation. Moreover, courts generally interpret "may" in a permissive way, as in "maybe." See La Bove v. Employers Ins. Co., 189 So. 2d 315, 317 (La. Ct. App. 1966); People v. Hoehl, 193 Colo. 557, 568 P.2d 484 (Colo. 1977).

Security Futures Two Years After the CFMA: An Assessment

By Paul B. Uhlenhop and John D. Ruark

I. Introduction

The Commodity Futures Modernization Act of 2000 ("CFMA")[1] established for the first time in the United States a regulatory scheme to permit trading of futures on individual equities and narrow-based equity indices. The CFMA made fundamental changes in the Commodities Exchange Act ("CEA"),[2] the Securities Act of 1933 (the "33 Act"),[3] the Securities Exchange Act of 1934 (the "34 Act"),[4] the Investment Company Act of 1940,[5] the Investment Advisers Act of 1940[6] and other federal acts[7] regarding futures on single stocks and narrow-based indices and even created a new name for such products: "security futures." The CFMA also made numerous other changes with the goal of coordinating the CEA with the other federal laws and regulation regarding derivative products.

In the late 1970s and early 1980s, trading volume of financial futures was growing rapidly and many new financial futures products were being introduced. The question as to whether the Securities and Exchange Commission ("SEC") or the Commodity Futures Trading Commission ("CFTC") had jurisdiction over such products was hotly contested until 1982 when SEC Chairman John Shad and CFTC Chairman Philip McBride Johnson reached what was known as the Shad-Johnson Accord which delineated jurisdiction between the two agencies and which temporarily prohibited single stock futures. What was intended to be temporary quickly turned seemingly permanent.

By explicitly authorizing security futures, the CFMA finally ended the "temporary" prohibition on single stock futures set out in the Shad-Johnson Accord. With the CFMA, Congress attempted to create a level playing field between futures regulation and securities regulation for security futures. As this article will discuss, a level playing field was achieved in certain respects. The CFMA was passed in a rush at the end of the year 2000 session of Congress and has certain inconsistencies, contradictions and gaps. Further, the legislation created an inherently cumbersome system because it largely provides for joint regulation of security futures. Nevertheless, the legislation is an important and helpful step forward. Much credit should also be extended to the regulators of security futures. The SEC and the CFTC as well as the National Futures Association ("NFA") and the National Association of Securities Dealers ("NASD") have made a monumental and to a large extent successful attempt to harmonize regulation between two different regulatory schemes, albeit schemes with essentially the same purposes.

This article is structured to discuss each of the major areas of the CFMA involving security futures and comment on the efficiency of the regulation.[8]

II. Intermediary Registration Provisions

The implementation of the CFMA's scheme of the CFMA and its implementation of intermediary registration has been a qualified success. The CFMA provided that a futures commission merchant ("FCM") or an introducing broker ("IB") may register by notice filing with the SEC as a broker-dealer ("BD"). However, a notice registered BD may effect securities transactions in security futures products only.[9] Likewise, the CFMA provides for notice registration of BDs as FCMs or IBs, with futures activities for such notice registrants limited to security futures products.[10] A FCM or IB notice registered as a BD is not

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required to be a NASD member and a BD that is a notice registered FCM or IB need not be a member of the NFA. The NFA has become a registered national securities association under the limited provisions of Section 15a(k) of the 34 Act. Both the CFTC and SEC have adopted rules permitting notice registration as provided in the CFMA and each of the self-regulatory organizations ("SROs") have adopted rules dealing with registration.[11] The rules as adopted provide for a relatively simple dual registration scheme. However, one difficulty that has arisen is due to the SEC's strict position that any securities activities by a noticed registered BD other than those directly involving security futures would require full BD registration absent some other exemption.[12] This means that notice registered BDs must register as full BDs to engage in any incidental activity involving security futures such as taking delivery of a security for a customer under a security futures settled by physical delivery. Furthermore, any transactions in the underlying securities to hedge a security future would have to be done in an account at a full BD. For this reason, many FCMs have elected full BD registration so that they would be able to provide to their customers full service, including combined account statements and hedging services. The lack of an exemption for activities incidental to security futures for a FCM or an IB notice registered as a BD is one small exception to the regulatory level playing field contemplated by the CFMA.

The NASD and the NFA have adopted rules providing for registration of individual associated persons dealing in security futures.[13] They have also created continuing education ("CE") training modules that, once completed, will permit Series 7 registered representatives and Series 3 associated persons to offer security futures products without having to take the other exam (i.e., Series 7 registered representatives will not have to take the Series 3 and vice versa). The CE program, jointly developed by the NFA and NASD, is available through either the NFA or NASD website and includes five modules:

1. Basic securities and securities options market (designed for Series 3 registrants);
2. Basics of futures and futures markets (designed for Series 7 registrants);
3. Information about the terms and conditions of security futures contracts and trading;
4. Major regulatory requirements for security futures; and
5. Supervision of sale and offer of security futures.

Series 3 registrants need complete only modules 1, 3 and 4. Current NASD registrants may qualify to offer security futures through having a Series 7 registration (or Series 42 options registration) and completion of modules 2 through 4.[14] New Series 7 registrants will have to take a new NASD test, the Series 43. The fifth module is intended for supervisors.

Under the NASD and NFA rules, members must designate one or more security futures principals for each office where the firm is engaged in security futures business. For firms that are NFA members only, a supervisor having the Series 30 and the required training elements may qualify as a security futures principal. Current supervisors who do not have the Series 30 exam may also qualify if the futures supervisor completed the required educational elements.[15] For NASD members (including those that are also NFA members) persons who have the Series 4 registered options principal or Series 9 or Series 10 examination are eligible to be a security futures principal. All NASD supervisors are required to pass the required education elements.[16] Both SROs require continuing education with respect to security futures.

The NASD and NFA also require members to review the Central Registration Depository for derogatory information on employers and prospective employees. NASD and NFA members must obtain copies of new employees' Forms U-4, U-5, 8-R or 8-T, as appropriate.[17]

While it is more of a theoretical issue, since the two marketplaces that trade security futures are electronic exchanges, exempt from BD registration are natural person floor traders and floor brokers effecting securities transactions only in security futures on a futures exchange registered as a contract market of which they are a member provided they do not accept orders from the public.[18] On the other side of the coin, there is an exemption from registration under the CEA for any individual floor broker or floor trader registered with the SEC trading security futures on a securities exchange if the floor broker or floor trader trades security futures and limits his or her futures activities to security futures.[19]

The regulatory registration scheme is well harmonized and appears to be working effectively. Considering that the regulatory goals of each of the two government agencies and the two SROs are essentially the same, dual registration remains cumbersome. However, if there must be a dual registration scheme, it probably works as reasonably well as one could expect. Importantly, state regulation of security futures is preempted, except for antifraud provisions.[20] Nevertheless, the SEC's failure to provide for incidental activities for FCMs and IBs engaged in security futures does create an arrangement that is probably different than the strictly level playing field envisioned by the CFMA.

III. Security Futures Sales Practices and Other Regulation

A. *General*

The CFMA left sales practices regulation largely to the SROs. While the views of the SROs about protection of the

investing public are conceptually similar, the methodology for implementing such protection is quite different. This difference resulted in a difficult and sometimes frustrating effort to harmonize the implementation of rules. However, by and large, the rules have been implemented in a way that should have little negative impact. FCMs and IBs notice registered as BDs are subject to the NFA's security futures rules. BDs notice registered as FCMs or IBs and BDs that are FCMs or IBs are all subject to the NASD's rules.

B. *Suitability*

While the NFA has long had a "know your customer" rule[21] somewhat similar to the "know your customer" rule in the securities industry,[22] the suitability requirements of the securities industry do not exist in the futures industry. The NFA adopted a suitability rule for security futures, including extensive provisions regarding obtaining, maintaining and verifying customer financial and background information.[23]

C. *Account Openings and Supervision of Accounts*

The NFA has long had special rules for opening discretionary futures accounts.[24] Likewise, the NASD has long had rules dealing with discretionary accounts and accounts trading options.[25] Under the new rules of each SRO,[26] all new accounts intending to trade security futures must be approved for trading by a security futures principal. Discretionary accounts also require the approval of a security futures principal. In addition, the security futures principal is responsible for reviewing discretionary activities in an account and documenting such review under the rules of the NASD and the NFA. After a customer has provided his financial and other information, the information must be sent to the customer for verification within 15 days after the account has been approved. If the firm becomes aware of any material change of customer information, the firm must furnish a copy of the changed information to the customer.

D. *Disclosure Document*

The SEC and CFTC have adopted rules requiring delivery of a disclosure statement when a customer opens an account for security futures.[27] The disclosure statement need not be acknowledged by the customer but it is expected that most firms will insist on customers acknowledging receipt and review of the document. Unfortunately, the final version of required disclosure document for trading security futures is lengthy, insuring that most customers will never read it.[28] Part of the document's length is the result of the CFMA scheme of cumbersome dual regulation which requires disclosures concerning various types of protections and differences between the securities financial responsibility regime and the futures financial responsibility scheme. The document also discusses in painstaking detail the risk involved in security futures. There may also be additional disclosure provided by the exchanges.[29] The good news is that each firm need not develop its own disclosure document. Nevertheless, the disclosure document is unlikely to have any effect on the success or failure of security futures as a product because customers are unlikely to wade through it.

E. *Best Execution*

"Best execution" is a securities concept that, in essence, means obtaining the best price currently available for customer orders. The obligation to seek best execution, originally a common law concept, has been championed with increasing vigor in recent years by the SEC. While futures brokers have always been obligated to use diligence in executing customer orders, many of the factors which apply to best execution analysis for securities simply do not apply in futures. For example, a securities broker-dealer typically has many choices as to the marketplace in which to execute a transaction. Futures, however, are not fungible across contract markets and thus the order routing issues that exist for securities firms do not exist for futures firms. Nevertheless, the NFA adopted a best execution rule by interpretation.[30]

F. *Communications with the Public*

Both the NASD and the NFA have long regulated communications to the public. The harmonization of rules follow the NASD rules on option communication rules and the futures rules dealing with options on futures.[31]

G. *Insider Trading and Front Running*

The securities laws have long prohibited trading on the basis of material non-public information. While the futures laws have long prohibited trading ahead of customer orders and prohibited intermarket front running in connection with broad based stock index futures, there was no comparable insider trading prohibition on material non-public information. As a result, the NFA adopted appropriate changes to its rules to incorporate these securities concepts.[32] The NASD also clarified its rule regarding front running.[33]

H. *Supervisory Procedures.*

Both the NFA rules and the NASD rules require written supervisory procedures with respect to all compliance requirements for security futures.[34]

I. *Other NASD and NFA Interpretive Positions and Rule Changes*

The NASD and the NFA, in addition to the rules and interpretations discussed above, amended a number of their rules to implement security futures trading and issued other interpretations discussed below.[35] Both the NASD and NFA rules require maintenance and reporting of complaints with respect to security futures.[36] The NASD extended its taping rule to security futures.[37] Security transactions by associ-

ated persons of an NASD member now include transactions at notice registered FCMs or IBs.[38] A similar rule was adopted by the NFA.[39] The research analyst conflict rules of NASD Rule 2711 were extended to experts in security futures.[40]

The NFA adopted Rule 2-37 entitled *Security Futures Products* which covers a variety of issues, such as compliance with 34 Act §§9(a), 9(b) and 10(b), written procedures with respect to applicable securities laws in connection with security futures, reporting certain types of complaints and disciplinary action within ten business days and requires maintenance of certain other information. In addition, the NFA issued an interpretive notice entitled *Obligation to Customers and Other Market Participants*[41] prohibiting trading on material non-public information, trading ahead of customer orders, block orders, communications and communications with the public. A second interpretive notice with respect to NFA Compliance Rule 2-9 is entitled *Special Supervisory Requirements for Members Registered as Broker-dealers Under Section 15b-11 of the Securities Act*[42] and deals with discretionary accounts, promotional material and correspondence, account approval, compliance with the securities laws, use and disclosure of the member's name, supervision of branch offices and guaranteed IBs, hiring of employees and entering into guarantee agreements and compliance meetings with associated persons. A further interpretive notice entitled *Compliance Rule 2-29 Use of Past or Projected Performance; Disclosing Conflicts of Interest for Security Futures Products*[43] deals with communications, particularly with respect to performance and disclosures of conflicts of interest. In addition, a number of other NFA rules have been amended as noted above.

In large part, the NFA Interpretive Notices deal with the rules which are currently effective for futures but provide explanations as to how they apply to security futures and how the concepts of those rules apply to security futures. In summary, the process of adapting harmonizing the NASD and the NFA rules for security futures was relatively smooth.

IV. Financial Responsibility Provisions

A. *In General*

Both the CEA and 34 Act have provisions for protection of customer cash and other property held by intermediaries. Both the CFTC and SEC have minimum capital requirements that registered intermediaries must meet. In addition, under the futures regulatory scheme, both purchaser and seller of a futures contract are required to post and maintain a performance bond. Such performance bond is still generally (and somewhat inappropriately) called margin. Under the securities regulatory scheme, the amount of money a BD may loan initially and during the term of the loan to customers to purchase securities is regulated. Further, the loan must be collateralized by a security interest in the securities. Such a collateralized loan to purchase securities is properly referred to as a margin.

B. *Protection of Customer Funds*

The CFMA provided a rational scheme for the protection of and handling of customer funds and property. FCMs and IBs notice registered as BDs are specifically exempt from Section 15(c)(3) of the 34 Act under which the SEC has promulgated SEC Rule 15c3-3[44] dealing with handling customer funds and property. Thus, a FCM or IB notice registered as a BD need not concern itself with the SEC scheme of customer cash and funds protection. In such case, any customer funds or securities must be held by an FCM pursuant to the CFTC segregation requirements.[45] Furthermore, the CFMA amended the Securities Investors Protection Act to provide that it would not cover customers of FCMs or IBs that are notice registered as BDs.[46] Conversely, the CFMA provides that a BD notice registered as a FCM or IB is exempt from the segregation requirements of the CEA. To implement this scheme, the SEC and the CFTC adopted rules that provide that, if a firm is registered as both a full BD and full FCM, security futures may be held for customers in a securities account, in a futures account or the firm may allow the customer to choose whether security futures will be held in a securities or a futures account.[47] However, if the firm is a notice registered BD, the security futures must be carried in a futures account. Likewise, if a BD is a notice registered FCM or IB, the security futures must be carried in a securities account. Customers must receive a risk disclosure statement providing certain disclosures concerning the choices available to a customer and the protections offered by each type of account. While this scheme is a logical extension of securities and futures customer protection requirements, it is a bit cumbersome and, due to the size of the disclosure document, it seems unlikely that customers will be able to make a knowledgeable election as to which type of account security futures will be carried in when such election is available to them.

C. *Capital Requirements*

The CFMA exempts notice registered BDs from certain provisions of the 34 Act including the SEC net capital rule.[48] Likewise, notice registered FCMs and IBs are exempt from the CFTC capital rule.[49] Although the SEC and CFTC capital rules are designed to work in tandem for dually registered firms, there have been a number of differences in interpretations and changes in the rules in recent years. For example, BDs that engage in certain types of commodity activities have greater haircuts under the SEC capital rule than they do under the CFTC capital rule. These differences existed before security futures and will continue thereafter and probably won't make too much

difference because dually registered firms must already comply with both sets of rules.

D. *Margining of Security Futures Products*

1. *The CFMA Requirement in General*

The CFMA provided that the Federal Reserve Board ("FRB") has authority to promulgate rules regarding margin for security futures products[50] but may delegate such authority to the CFTC and SEC which, under such delegation, will jointly prescribe rules pursuant to the mandate set forth in the CFMA. After a significant jurisdictional struggle, the SEC and CFTC developed joint rules for margining security futures products. The development of margin rules was a struggle in part because the CFMA provided that the rules meet several specific seemingly inconsistent criteria including the following requirements:

i. the margin requirements for a security future product be consistent with the *margin requirements for comparable option contracts traded on any exchange registered pursuant to section 6(a)* of this title; and

ii. initial and maintenance margin levels for a security future product not be lower than the lowest level of margin, exclusive of premium, required for *any comparable option contract* traded on any exchange registered pursuant to section 6(a) of this title, other than an option on a security future;

except...

d. to ensure that the margin requirements (other than levels of margin), including the type, form, and use of collateral for security futures products, are and remain consistent with the requirements established by the Board, pursuant to subparagraphs (A) and (B) of paragraph (1) (emphasis added).[51]

The CFTC and the SEC first proposed joint rules[52] that met with considerable opposition, particularly from the futures industry, because the rules required all transactions to be carried in a Regulation T account. This would have made it difficult, if not impossible, for FCMs to carry security futures accounts because futures margining is significantly different than the concepts underlying Regulation T. Further, software and other systems of the futures industry would have required significant modification to carry such accounts. The comments also raised a number of questions concerning calculation of equity, portfolio margining, offsets, time for margin calls, types of acceptable collateral and importantly futures long option value in futures accounts carrying security futures. There was also considerable objection to minimum and initial margin levels for carrying long or short security futures positions at 20% of the current market value of such position subject to certain lower margin for certain offset positions. This level appeared to have been mandated by Congress because of the requirement that the margin requirements for security futures be comparable to securities option contracts traded on securities exchanges. Since a futures good faith deposit is different than securities collateral margin, the Congressional mandate placed the SEC and the CFTC in a difficult position because the option margin at 20% would not be comparable to 20% margin on a futures position. In the final rules,[53] the SEC and the CFTC devised a regulatory scheme that continued the proposed 20% margin requirements but provided other relief for futures firms.

The final rules do provide that security futures held in a securities account are subject to Regulation T and security futures held in a futures account are not. However, security futures held in a futures account must comply with certain aspects of Regulation T concerning account administration, type, form, certain types of collateral, calculation of equity, withdrawals from accounts and treatment of undermargined accounts. The final rules permit security futures intermediaries to include in futures accounts the net value of long options and open trade equity for purposes of computing the equity in the account. In addition, in determining whether margin requirements are met, the final rules permit security futures intermediaries to compute equity in accordance with applicable SRO authority rules subject to consistency with Regulation T. While the final rules have additional margin offsets, security futures have no value for margin purposes. Various changes were made with respect to collateral so that money market funds and certain other collateral would be permitted but not letters of credit. Importantly from a margin standpoint, accounts of the same type (*i.e.*, all futures accounts or alternatively all securities accounts) may be consolidated for determining required margin for security futures. The margin rules have increased margin requirements for futures day traders. Accounts need not be liquidated for failure to timely deposit margin unless the account is in deficit. The time for collection for margin varies by the firm's examining authority. The changes permitted futures firms to compute and carry security futures in futures accounts with the current futures account software and other systems with some modifications. This avoided putting futures intermediaries at significant disadvantage in having to reprogram all of their systems to comply with Regulation T.

In summary, a number of compromises were made from the originally proposed margin rules which are largely workable and should not present significant burden. The biggest problem, however, is the 20% margin, while in line with equity and index options, is significantly higher than the margin required for similar types of futures products, such as futures on broad indices. The rules provide that portfolio margining may be used for customers provided the

CFTC and SEC agree on a joint portfolio margining system. No such agreement has been reached and it appears that any such agreement is several years away. The final adopting release stated that the agencies were going to continue to attempt to develop a portfolio margining system to allow portfolio margining for customers using security futures products. This would be an obviously important step. However, the SEC's reluctance to adopt the futures risk margining system has been a barrier to adopting lower margin for portfolios that are in effect hedged. It remains to be seen whether the 20% margin requirement, which is substantially higher than normal for futures, will limit the growth of security futures. Philip McBride Johnson, chairman of the CFTC at the time that the Shad-Johnson Accord was originally devised, has indicated his belief that the high margin level effectively "kneecaps" security futures.[54] It also may have a negative impact on the ability of the United States exchanges to trade security futures since security futures margin on foreign exchanges is significantly less. Furthermore, foreign exchanges already use a customer portfolio risk margining system. Hopefully, the SEC and the CFTC will agree on a customer portfolio risk margining system similar to the current system used globally in the futures industry so that security futures will not be hampered by excess margining.

E. *Maintenance Margin Requirements of Self-Regulatory Organizations*

The SROs' maintenance requirements follow the SEC and CFTC rules and provide exemptions for market participants such as market makers.

F. *Reporting and Recordkeeping Requirements*

BDs and FCMs are required to report through their SRO to the SEC or the CFTC with annual audited financials and interim financial reports.[55] The SEC has exempted FCMs and IBs notice registered as BDs from filing such reports with the SEC and the CFTC has likewise exempted BDs notice registered as FCM or IB from filing financial reports with the CFTC.[56] The CFMA did create a level playing field in risk assessment report filings by exempting notice registered BDs from the SEC risk assessment reporting regime and notice registered FCMs or IBs from the CFTC risk assessment regime.[57]

The SEC and the CFTC quite sensibly provided that, with respect to certain recordkeeping and books and records rules, the SEC rules would apply to security futures carried in securities accounts and the CFTC rules would apply to security futures carried in futures accounts. However, either regulatory agency has access to records with respect to security futures.[58] Further, the early warning notice requirement of SEC Rule 17a-11 has been amended so as to not be applicable to FCMs that are notice registered IBs and similar provisions under the CFTC regulations are not applicable to notice registered FCMs or IBs.[59] These rules seem to be quite sensible and remove regulatory burdens. In this case, the dual regulatory scheme seems to be sound.

G. *Confirmations*

The SEC amended Rule 10b-10 to clarify the necessary disclosures on confirmations of transactions for notice registered and full BDs effecting transactions in security futures products. The amendments also provide that BDs effecting transactions in security futures products *in futures accounts* do not have to disclose all of the information ordinarily required, but are required to disclose specific information and notify customers that certain additional information will be available on written request.[60] The new rule also exempts BDs from effecting transactions in security futures products in a futures account under the disclosure requirements of Section 11(d)(2) of the 34 Act.[61] This confirmation scheme follows the SEC's rules but in a number of respects permits security futures transactions in futures accounts to use a futures style confirmation but provide additional information at the customer's request. This compromise permitted the futures industry to avoid a significant amount of costly reprogramming.

V. Miscellaneous Trading Rules

The uptick rule applicable generally to short sales of equity securities does not apply to transactions in security futures.[62] Likewise, ownership of security futures does not equate to ownership of the underlying security for purposes of SEC Rule 10a-1 or 10a-2. The rules with respect to borrowing stock will not be applicable at the time of selling a security future but may become important in the event of delivery of the underlying security.

- Block trade execution is subject to complex rules by the two exchanges that are currently trading security futures. The NFA also issued interpretive guidance on block orders.[63] Some exchanges for physical ("EFPs") are also permitted under the rules of both of the exchanges, but transitory EFPs are not permitted.
- If trading of a security underlying security futures or securities representing more than 50% of a narrow based stock index is halted, trading in the security futures product also must be halted.
- The CFTC has amended its Form 102 to provide for large trader reporting in established reporting levels for individual security futures contracts. Furthermore, the CFTC and the exchanges have adopted position limit rules for security futures.
- The trading rules and interpretations issued by the SEC, CFTC, NASD, NFA and the applicable exchanges seem to be very workable and should avoid most duplication and inefficiency inherent in the dual regulatory scheme.

VI. SEC Interpretive Release with Respect to the Impact of Security Futures on Various Provisions of the Securities Laws

Because security futures are deemed to be securities, numerous provisions under the 33 Act, the 34 Act and other provisions of the federal securities laws apply or may apply to them. To deal with this, the SEC issued an interpretive release[64] which provides guidance in the following areas:

1. SEC Rule 144;
2. Disclosure requirements and short swing profit recovery under 34 Act Section 16;
3. Beneficial owner disclosure requirements under 34 Act Regulation 13D with respect to filing notice of ownership and certain other provisions;
4. Duty of best execution;
5. Short sale regulation, 34 Act Rules 10a-1 and 10b-3;
6. Short tender rule, 34 Act Rule 14e-4;
7. Purchases outside of a tender offer, 34 Act Rule 14e-5;
8. Regulation M regarding anti-manipulation rules involving distributions of securities;
9. Eligible OTC derivative instruments, 34 Act Rule 3b-13;
10. Conflicts associated with proprietary trading and trading for discretionary accounts by exchange members, 34 Act, §11(a);
11. Extension of credits, 34 Act, §11(d) and 34 Act Rule 10b-16 with respect to interest disclosure; and
12. Ancillary securities activities by notice registered BDs.

In large part, these interpretations are sensible. In certain cases where security options or other derivatives are not treated as a purchase or sale of security under the securities laws, there is like treatment accorded to security futures. The one area where the SEC failed to provide adequate guidance is ancillary securities activities by notice registered BDs. The SEC is taking a very strict view that any securities activities by a notice registered BD other than as specifically permitted for security futures would require registration absent some other exemption.[65] As discussed above, this strict position means that notice registered BDs are prohibited from any securities activity for customers even when incidental to security futures.

VII. Foreign Security Futures

The CFMA contains several provisions concerning foreign security futures traded on foreign exchanges. The CFMA[66] appears to provide a prohibition on effecting transactions in security futures products that are not listed on a United States exchange or contract market. Further, the CFMA includes a prohibition against any person "offering or executing, confirming or conducting business anywhere in the United States" for the purposes of dealing in security futures products unless the transaction is effected on a contract market or a national securities exchange.[67] However, both of these provisions contain parallel provisions providing that "to the extent necessary and appropriate in the public interest..." the CFTC and the SEC shall jointly provide regulations permitting the offer and sale to United States persons of foreign securities products traded on non-United States markets.[68] Furthermore, United States "eligible contract participants" and FCMs are extended relief by the CFMA which provides that nothing in the CFMA "is intended to prohibit such a person from purchasing on an unsolicited basis security futures products listed on a foreign exchange to the same extent such United States person may purchase the underlying securities provided that the underlying securities are traded primarily on a non-United States market."[69] Notwithstanding this apparent relief mandated by Congress, the SEC's Division of Market Regulation has interpreted the CFMA to mean that *no United States person may trade security futures products* listed on a foreign market *nor may United States intermediaries effect transactions even for non-United States persons* until joint rules are promulgated permitting the offer and sale of foreign securities to United States persons. However, by no-action letter, United States BDs and FCMs may *clear and carry*, but not *execute*, foreign security positions for non-United States persons.[70] It is hard to conceive an appropriate regulatory purpose behind the SEC's action other than its general dislike of futures products. The SEC is apparently arguing that there is an ambiguity in the CFMA and that it will not take any action until Congress clarifies the supposed ambiguity. One wonders what regulatory purpose is served.

VIII. Conclusion

The staffs of the SEC, CFTC, NASD, NFA and the Securities Industry Association and Futures Industry Association special joint committee labored mightily under an enormous time pressure to develop a regulatory scheme which would be rational and follow the Congressional mandate of dual registration yet not be overly cumbersome or inefficient. By and large, the scheme that emerged *is* rational and relatively efficient considering the inherent problems of dual regulation. An alternative would have been to keep the separation between futures and securities, allowing each regulatory scheme to operate independently of the other, but require each of the regulatory schemes to conform to certain broad principles set forth by Congress in legislation. This possible choice was rejected by Congress even though the regulatory goals and concepts of the securities industry and the futures industry are essentially the same.

There were of course some failures. As noted above, the margin for security futures products does not include

portfolio margining although it is hoped that it may be available in the not too distant future, particularly in view of the 20% margin requirement. The current margin levels affect the viability of security futures because it makes the product more expensive then other futures. It will probably also have a negative effect internationally where portfolio margining and lower margins are available for similar products being traded in European markets. However, there were numerous successes dealing with margin, which was one of the tougher areas, including use of options values and other changes that were made through the final rules.

The current limitations imposed on FCMs and IBs that are noticed registered BDs preventing them from executing orders or taking delivery for securities underlying security futures or other activity incidental to security futures transactions makes it almost mandatory that an FCM become a fully registered BD if it is to handle security futures for customers. In addition, full BD registration permits a BD/FCM to offer combined account statements and a variety of other services to customers. It is the author's experience upon being consulted by a number of futures firms about notice registration that all but one elected to become fully registered BDs rather than notice registered BDs. It may be that, after a few years, there will be few, if any, notice registered BDs.

The disclosure document is certainly not a model of conciseness and although supposedly written in plain English, it is hard to believe that many customers will in fact carefully read such a lengthy document.

The SEC's position regarding foreign futures seems to be a bit of jurisdictional bias which has certainly hurt large and medium United States firms with branch offices and affiliates in Europe. It is hoped that the SEC will reconsider its position for a variety of reasons including the proposed retaliatory counterattack of the European Union on United States securities and futures products in Europe.

Without the dual regulatory schemes, the legislation would probably never have passed Congress. In that sense, the dual regulatory scheme, even with its inefficiencies, was probably necessary for trading of security futures to begin in the United States. Another great success of the legislation was the necessary interaction between the securities regulators and the futures regulators. There were many tough issues that needed to be hammered out. Each of the regulatory systems have their own regulatory and jurisdictional bias which had to be put aside. The staffs of the SEC, CFTC, NASD, and NFA worked very hard and diligently and by and large attempted in good faith to put aside regulatory and jurisdictional bias and to reach common ground. In some cases, this took some time and very hard negotiations. However, this has provided one truly positive fringe benefit: the education of the securities regulators about the futures industry and vice versa. This interaction should prove invaluable to both agencies. In addition, as with any new product, no matter how carefully crafted initially, rules will need to be changed with experience and because of market changes. ■

Notes

1 Pub. Law 106-554.

2 7 U.S.C. §1 *et seq.*

3 15 U.S.C. §77a *et seq.*

4 15 U.S.C. §78a *et seq.*

5 15 U.S.C. §80a-1 *et seq.*

6 15 U.S.C. §80b-1 *et seq.*

7 *See e.g.,* Gramm-Leach-Bliley Financial Modernization Act, Public Law 106-102, 113 Stat. 1338.

8 This article assumes that the reader has an understanding of the basic regulatory scheme of the CFMA and is familiar in general with the rules and interpretations dealing with security futures. It should be noted that this article does not discuss the regulation of markets trading security futures which is beyond the scope of this article.

9 34 Act §15A(k), 15 U.S.C. oA(k).

10 CEA §4f(a)(4)(A), 7 U.S.C. §6f(a)(4)(A).

11 SEC Rule 15b-11, 17 C.F.R. 240.15b-11; NASD Rule 1060; NFA 204(a)(4); NFA Interpretive Notice: "Rule 2-4: Broker-Dealer Registration Requirements for Security Futures Products", NFA Manual ¶9044.

12 SEC Interpretation: "Commission Guidance on Application of Certain Provisions of Securities Act of 1933, the Securities Exchange Act of 1934 and Rules Thereunder to Trading in Security Futures"; SEC Release Nos. 33-8107; 34-46101 67 F.R. 43,234, (June 27, 2002).

13 NASD Notice to Members 2-73 (November 2002).

14 NFA Interpretive Notice: "Rules 2-7 and 2-24 and Registration Rule 401: Proficiency Requirements for Security Futures Products" (NFA Manual ¶9049); NASD Rules 1032(a)(2)(E) and 1032(d).

15 NFA Compliance Rule 2-7(b); NFA Interpretive Notice "Rule 2-9: Special Supervisory Requirements for Members Registered as Broker-dealers Under Section 15(b)(11) of the Securities Exchange Act of 1934", NFA Manual ¶9042 (hereinafter called "NFA Special Supervisory Interpretation").

16 NASD Rule 1022(f) and (g).

17 NASD Rule 3010(e); NFA Special Supervisory Interpretation.

18 34 Act §15(b)(11)(B), 15 U.S.C. §78o(b)(11)(B).

19 CEA §4f(a)(4)(A), 7 U.S.C. §6f(a)(4)(A).

20 34 Act §28(a), 15 U.S.C. §78bb(a); CEA §12(e), 7 U.S.C. §14(e).

21 NFA Rule 2-30.

22 *See* NYSE Rule 405.

23 NFA Rule 2-30(j); NASD Rule 2865.

24 NFA Compliance Rule 2-8.

25 NASD Rules 2510 & 2860.

26 NFA Rule 2-30; NFA Special Supervisory Interpretation; NASD Rule 2865.

27 CFTC Rule 41.41(a), 17 C.F.R. 41.41(a); CFTC Rule 1.55(h), 17 C.F.R. 1.55(h); SEC Rule 15c3-3(o), 17 C.F.R. 240.15c3-3(o); NFA Rule 2-30(j)(1); NFA Interpretive Notice: Rule 2-30(B) "Risk Disclosure Statement for Security Futures Contracts", NFA Manual ¶9050; NASD Rule 2865(b)(16)A.

28 The NFA version is 26 pages; the NASD version is 61 pages. While the content is virtually identical, the difference in length is due to different formatting.

29 *See, e.g.,* NQLX Rule 327(a)(2). The NQLX disclosure is brief at only two pages.

30 NFA Interpretive Notice: "Rule 2-4 Regarding Best Execution Obligations of NFA Members Registered as Broker-Dealers Under Section 15b(11) of the Securities Exchange Act of 1934" NFA Manual ¶9048; Rule 204; SEC Release Nos. 33-8107 & 34-46101, 67 F.R. 43,234, p. 11 (June 27, 2002).

31 *See* NFA Rule 2-29(j); NFA Special Supervisory Interpretation"; NFA Interpretive Notice "Obligation to Customers and Other Market Participants", NFA Manual ¶9041; Interpretive Notice, NFA Compliance Rule 2-29: "Use of Past or Projected Performance; Disclosing Conflicts of Interest", NFA Manual ¶9043; NASD Rule 2210; NASD Rule 2711; NASD Interpretation 2210-7; NASD Notice to Members 02-73 (November 2002).

32 NFA Interpretive Notice "Obligations to Customers and Other Market Participants", NFA Manual ¶9041.

33 NASD Interpretation 2110-3.

34 NASD Rule 3010; NFA Rules 2-9, 2-37.

35 NASD Notice to Members 02-73 (November 2002); NFA Rule 2-29(j); NFA Rule 2-30(j); NFA Rule 2-37.

36 NASD Rule 3070; NFA Rule 2-37(d)(e)(f); NFA Special Supervisory Interpretation.

37 NASD Rule 3010(b)(2).

38 NASD Rule 3050.

39 NFA Special Supervisory Interpretation.

40 NFA Interpretive Notice Rule 2-29: "Use of Past or Projected Performance; Disclosing Conflicts of Interest for Security Futures Products", NFA Manual, ¶9043; NASD Rule 2711.

41 NFA Manual, ¶9041.

42 NFA Manual ¶9042.

43 NFA Manual ¶9043.

44 17 C.F.R. 240.15c3-3.

45 CEA §4(d), 7 U.S.C. §6(d); CFTC Rule 1.10 *et seq.* 17 C.F.R. 1.10 *et seq.*

46 17 U.S.C. §78aaa *et seq.*

47 CFTC Rule 41.41(a)(b)(c), 17 C.F.R. 41.41(a)(b)(c); SEC Rule 15c 3-3(o), 17 C.F.R. 240.15c3-3(o).

48 34 Act §15(b)(11)(B), 15 U.S.C. §78o(b)(11)(B).

49 34 Act §4f(a)(4)(A), 7 U.S.C. §5f(a)(4)(A).

50 34 Act §7(c)(2), 15 U.S.C. §78g(c)(2).

51 34 Act §7(c)(3)(B), 15 U.S.C. §78g(c)(3)(B).

52 SEC Release No. 34-44853, 66 F.R. 50,720 (October 4, 2001).

53 17 C.F.R. 41.43 to 48; SEC Rules 400 through 404, 17 C.F.R. 240.400 to 404.

54 *See* Johnson, *Single Stock Futures Have Been Damaged Goods from the Start*, Financial Times, Letters to Editor, Feb. 13, 2003.

55 SEC Rule 17a-5, 17 C.F.R. 240.17a-5; CFTC Rule 1.16, 17 C.F.R. 1.16.

56 SEC Rule 17a-5(l)(4), 17 C.F.R. 240.17a-5(l)(4); 43 CFTC Rule 41.41(a)(b)(c), 17 C.F.R. 41.41(a)(b)(c); SEC Rule 15c3-3(o), 17 C.F.R. 240.15c3-3(o).

57 34 Act §15(b)(11)(B), 15 U.S.C. 78o(b)(11)(B); CEA §6f(a), 15 U.S.C. §7f(a).

58 SEC Rules 17a-3 & 4, 17 C.F.R. 240.17a-3 & 4; CFTC Rule 41.41(d) & (e), 17 C.F.R. 41.41(d) & (e).

59 SEC Rule 17a-11(i), 17 C.F.R. 240.17a-11(i).

60 *See* SEC Rule 10b-10(e), 17 C.F.R. 24010b-10(e); SEC Release No. 34-46471, 67 F.R. 58,302 (September 13, 2002).

61 SEC Rule 11d2-1, 17 C.F.R. 240.11d2-1.

62 SEC Rules 10a-1 & 2; 17 C.F.R. 240.10a-1 & 2.

63 Supra FN 40.

64 SEC Interpretation: "Commission Guidance on Application of Certain Provisions of Securities Act of 1933, the Securities Exchange Act of 1934 and Rules Thereunder to Trading in Security Futures", SEC Release Nos. 33-8107; 34-46101; 67 F.R. 43,234, (June 27, 2002).

65 For certain securities activities incidental to futures on government securities are exempt by reason of SEC Rules 3a43-1 and 3a44-1, 17 C.F.R. 240.3a43-1 & 3a44-1.

66 15 U.S.C. 78(h); CEA 2(a)(11).

67 CEA §2a(1)(F); 7 U.S.C. §§2.2a & 4.

68 *Id.*

69 *Id.*

70 SEC No-Action Letter to the Futures Industry Association and the Securities Industry Association, Fed.Sec.L.Rpt. CCH [2002] ¶78327 (August 30, 2002).

Letter from the Editors: *(continued from page 2)*

- Do the Section 2 exclusions for hybrid instruments and swap transactions have a retroactive effect for pre-CFMA transactions, *i.e.,* did the exclusions clarify and render legal certainty to the status of pre-CFMA transactions?
- Section 9(a)(2) makes it a criminal felony to manipulate the price of any commodity in interstate commerce, or for future delivery on or subject to the rules of any registered entity. Is Section 9(a)(2) exclusively enforceable by a Department of Justice criminal prosecution or is it also a civil prohibition administratively enforceable by the CFTC? If it is enforceable by the CFTC, then what is the necessity for Sections 6(c) and 6(d) to specify that the CFTC may commence a civil enforcement action against any person who engages in a manipulation or "otherwise is violating or has violated the Act"?
- Does the Section 4c(a) wash trading prohibition apply to post-CFMA transactions that qualify as excluded swap transactions under Section 2(g) of the CEA, regardless of whether they are cash-settled or physically-settled?
- May a credit default swap transaction documented on an ISDA Master Agreement be characterized as a securities-based swap agreement, a non-securities based swap agreement, or a securities option that is excluded from the definition of a swap agreement, depending on the nature of the credit event or the type of payment indexation?
- May foreign currency and government security products that are excluded from the coverage of the CEA under Sections 2(c), 2(f) or 2(g) be traded on exempt boards of trade under Section 5d of the CEA?
- Why does almost every drafter of a swap master agreement schedule that contains an eligible contract participant representation incorrectly cite the statutory reference as Section 1(a)(12) instead of Section 1a(12)?

Next month the *Report* will have a number of articles concerning recent changes to the world of swaps documentation. Also in May, the Futures Industry Association's Law & Compliance Division will hold its annual meeting in Baltimore, promising interesting programs, crabs and comedy (at an evening event at a Baltimore comedy club, not necessarily at the program). We congratulate the FIA on putting together this yearly event that is a vital continuing education venue for the futures and derivatives compliance and legal community. ■