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Capital, Customer Funds, and Margin After the Commodity Futures Modernization Act of 2000

By Paul B. Uhlenhop

I. Introduction

The Commodity Futures Modernization Act of 2000 ("CFMA"),1 made fundamental changes in the Commodities Exchange Act ("CEA"),2 the Securities Act of 1933,3 the Securities Exchange Act of 1934 (the "34 Act"),4 the Investment Company Act of 1940,5 the Investment Advisers Act of 19406 and other federal acts.7 The goal of the legislation was to coordinate the CEA with the federal securities laws and other financial regulation of derivative products, particularly futures on single stocks and narrow-based indices, derivatives and hybrid products which have mixed elements of securities, futures and bank products. The CFMA also modernized and changed the CEA, simplifying regulation of contract markets and providing for the creation of different types of derivative markets. It also provided for direct regulation of the clearing function and registration and regulation of clearing houses.

The purpose of this paper is to focus on changes affecting the financial responsibility requirements of broker-dealers ("BD"), futures commission merchants

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("FCM") and Introducing Brokers ("IB") as a result of the CFMA and subsequent regulations. The paper also discusses the margining of security futures products as mandated by the CFMA and as implemented by the rules of the Commodity Futures Trading Commission ("CFTC") and the rules of the Securities and Exchange Commission ("SEC").

II. Background

One of the major goals of the CFMA was that securities and futures markets and intermediaries have a level regulatory field when trading futures on individual securities and narrow based indices of securities (security futures). In order to accomplish this goal, the CFMA provides that commodities markets (any contract market or derivatives transaction execution facility) that are trading security futures products may notice register with the SEC as a national securities exchange.[8] Likewise, the CFMA provides that national securities exchanges or alternative trading markets trading security futures may register as contract markets by notice registration with the CFTC.[9] With respect to intermediaries, an FCM or IB may register by notice filing with the SEC as a BD if it would be required to register only because it affects transactions in security futures products on an exchange registered with the SEC.[10] Likewise, the CFMA amends the CEA to provide for notice registration of BDs as FCMs or IBs as long as the FCM or IB limits its solicitation to security futures products traded on a contract market or registered derivatives exchange.[11] The provision with respect to notice registration of FCMs or IBs as a BD requires such registration if the FCM notice registered BD proposes to trade any security futures product. However, a BD registered by notice filing as an FCM or IB need only register if it is going to trade a security futures product on a contract market or derivatives exempt trading facility.

The CFMA specifically provides for exemptions for notice filed BDs from certain of the parts of the 34 Act and related rules. Likewise, it provides exemptions for notice filed FCMs or IBs from certain parts of the CEA and related rules. Specifically, FCMs or IBs registered as BDs pursuant to the provisions of the CFMA are exempt from the following sections of the 34 Act:

1. Section 8;
2. Section 11,
3. Sections 15(c)(3) and (c)(5);
4. Section 15b;
5. Section 15c; and
6. Sections 17(d), (e), (f), (g), (h) and (i).[12]

It should be noted that FCM and IB notice registered BDs must be a member of a futures association registered with the SEC as a registered national securities association.[13] The National Futures Association ("NFA") has applied to become a registered national securities association under the limited registration provisions of Section 15a(k) of the 34 Act. BDs that are notice registered as FCMs or IBs are exempt from a number of provisions of the CEA, including the following:

1. Subsections (b), (d), (e), and (g) of Section 4c;
2. Sections 4d, 4e and 4h;
3. Subsections (b) and (c) of this Section;
4. Section 4j;
5. Section 4k(1);
6. Section 4p;
7. Section 6d;
8. Subsections (d) and (g) of Section 8; and
9. Section 16.[14]

It should be noted that a BD notice registered as an FCM or IB or exempt floor broker or floor trader need not become a member of a futures association registered under Section 17.[15]

Also exempt from BD registration are floor traders and floor brokers who are natural persons effecting transactions only in security futures on a futures exchange registered as a contract market of which they are a member as long as they do not accept orders from the public.[16] It should also be noted that an individual floor broker or floor trader is exempt from registration under the CEA if the floor broker or floor trader trades security futures on a securities exchange and is registered with the SEC and limits his or her futures activities to security futures.[17]

Importantly for purposes of this paper, the CFMA provides a framework for margining security futures products.[18] The margins for particular security futures products are to be set by the Federal Reserve Board, which may delegate responsibility to the CFTC and the SEC. In the event that the SEC and CFTC do not agree on margin rules pursuant to the provisions of the CFMA, the Federal Reserve Board shall prescribe the appropriate margin for security futures pursuant to the terms of the CFMA for security futures. The Federal Reserve Board has delegated the authority to the CFTC and the SEC. However, the CFMA provides, as discussed below in more detail, the framework for margining of security futures products. Specifically, it requires among other requirements that margin for a security futures product be consistent with the margin requirements for comparable option contracts traded on a national securities exchange.

III. Protection of Customer Funds

A. General

The CEA has provisions for protection of customer cash securities or other property held by an FCM. Likewise, the 34 Act has provisions for the protection of customer cash, securities and other property held by a BD. Under the CEA, customer funds and customer securities must be held in segregation by a third party financial institution.[19] Under Section 15(c)(3) of the 34 Act, the SEC has promulgated Rule 15c3-3 which requires that BDs maintain reserve deposits with a third party financial institution.[20] The amount of these deposits are computed weekly or monthly based generally upon funds owed to customers minus certain funds due the BD. Rule 15c3-3 also requires that fully paid securities of customers be held in the control and possession of the BD within the meaning of the SEC rule.

Under the CFMA, the handling of customer funds and securities appears to be fairly straight forward. FCMs and IBs notice registered as BDs are specifically exempt from Section 15(c)(3) of the 34 Act under which is promulgated SEC Rule 15c3-3.[21] Thus, if an FCM is notice registered and is *not otherwise a BD* because it trades only futures, futures options and security futures, it need not concern itself with SEC Rule 15c3-3. In such case, any customer funds or securities would be held by the FCM pursuant to the CFTC segregation requirements. Furthermore, the CFMA amended the Securities Investors Protection Act to provide that it would not cover customers of FCMs that are registered as a BD pursuant to Section 15(b)(11)(A) of the 34 Act.[22] Conversely, the CFMA provides that a BD notice registered as an FCM or IB or a floor broker or floor trader exempt from registration with the CFTC, are exempt from the segregation requirements of the CEA.[23]

B. Proposed Rules

The CFTC and SEC jointly announced on September 25, 2001 proposed rules with respect to customers' accounts holding security futures products (the "joint release").[24]

1. CFTC Proposed Rules

The CFTC proposes to amend Rule 1.55[25] dealing with risk disclosure statements to provide for certain disclosures

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to customers that will effect transactions in security futures products. Under CFTC proposed Rule 41.42, the disclosure statement must state in the case of a firm that is fully (not notice) registered as both a BD and an FCM, whether security futures will be held for the customers by the firm:

1. in a securities account;
2. in a futures account; or
3. at the election of the customer in either a securities or a futures account.

The CFTC also proposes to amend its definitional rule to include a definition of a "securities account" and a "futures account". If the firm is an FCM and a notice registered BD, the security futures must be carried in the futures account. Likewise, if a BD is a notice registered FCM or IB, the security futures must be carried in the securities account. In addition, disclosures must be made as to Securities Investor Protection Act ("SIPA") and SEC Rule 15c3-3[26] protections and §4d of the CEA[27] segregation protection for each of the two types of accounts. The disclosure also must disclose the absence of the applicable protection in the event security futures are to be held only in one type of account. If the customer elects to maintain security futures in a securities account, the lack of protection of §4d segregation and, conversely if the customer elects to maintain security futures in a futures account, the lack of SIPA and Rule 15c3-3 protection. The proposed rule also would require that a customer acknowledge receipt of the disclosure. The rule also provides that in the event that a fully registered BD and FCM changes the type of account in which security futures may be held, the registered BD must give notice to customers and permit the customer to move the account, together with appropriate disclosures as to the protections under one scheme and the lack of protections under the alternative protection scheme.

2. SEC Proposed Rules

The SEC proposes a parallel scheme of regulation. Rule 15c3-3 was amended to add new definitions of "securities account" and "futures account" and new subsection (o). Rule 15c3-3(o) parallels the choices available with respect to the CFTC rules described above. If the firm is both a fully registered BD and an FCM, it may elect to permit customers to carry security futures in either a futures account or a securities account or the firm may elect only to carry security futures in either securities accounts or futures accounts. If the firm is a notice registered BD, security futures must be carried in a futures account. If the firm is a notice registered FCM or IB, the positions must be carried in a securities account. The same disclosures must be made under Rule 15c3-3(o) as under the CFTC rules. In the case of a fully registered BD and FCM, the firm must disclose whether it will permit customers to carry the security futures in a futures account, in a securities account or elect to carry the security futures position in either a futures or securities account. There must be a description of the SIPA and Rule 15c3-3 protections, and the protection of segregation under §4d of the CEA. The firm must also describe the protections that a customer would forego under one scheme or the other. The firm would also be required to obtain the customer's acknowledgment of receipt of the disclosure. Like the CFTC rule, the SEC rule requires disclosure to be made to customers if the firm changes its procedures with respect to the type of account in which security futures may be held.

C. Segregation Opt Out Rule

The CFMA amended the CEA to permit a Board of Trade to elect to operate as a Derivative Transaction Exclusion Facility ("DTEF") in lieu of seeking designation as a Contract Market.[28] A DTEF may authorize FCMs to offer to its customers that are "Eligible Contract Participants"[29] as defined in the CFMA (generally large institutions), the option to *elect to have their funds* that are carried by an FCM for purposes of trading on the DTEF *not separately accounted for and segregated.*[30] The CFTC has adopted a new Rule 1.68 to provide for such opt out of segregation for such customers.[31] Rule 1.68 permits a DTEF to authorize its FCM members to offer to its Eligible Contract Participant customers the right to "opt out" of segregation for their funds and assets held for purposes of trading on DTEF. The Rule provides that the FCM must make a disclosure to the customer with respect to the election, including an explanation of the advantages and possible disadvantages of segregation. The Rule provides that an Eligible Contract Participant may revoke its election (opt-in to segregation) upon five business days notice. It is interesting to note that if the customer opts out under CFTC Rule 1.68, the CFTC capital rule provides that the funds must be taken into consideration in computing the capital of the FCM.[32] The CFTC's adopting release explains that an opt-out customer would receive the bankruptcy treatment of a non-public customer and not a general creditor, which in essence means that the customer would come ahead of general creditors for customer funds but behind customers whose funds and assets were held in segregation.[33] Although an opt out customer may move its funds between its segregated account and its opt-out account, the opt-out account may not be used to secure the segregated account if there is a deficit. However, the reverse would be true.

Interestingly, the CFTC appears not to have considered in adopting CFTC Rule 1.68 the impact on BDs that are FCMs. Under SEC Rule 15c3-3, a futures customer's funds held in segregation accounts are excluded from SEC Rule 15c3-3 calculation for the BD's reserve deposit.[34] The net balance, however, may be reduced by netting the regulated

and non-regulated commodity account if there is a deficit in the regulated commodity account held in segregation.[35] Funds held in the secured account under CFTC Regulation 30.7 are also excluded from the Rule 15c3-3 computation.[36] As a result of these interpretations, if a customer of an FCM that is registered as both an FCM and BD opts out of segregation pursuant to CFTC Rule 1.68, the customer's funds appear to have to be included as part of the BD's 15c3-3 computation. However, if the FCM is notice registered with the SEC as a BD, the FCM would be exempt from SEC Rule 15c3-3 and would not have to make a Rule 15c3-3 computation and would not have to make a 15c3-3 deposit with respect to the customer's funds. With respect to security futures, this may give FCMs notice registered with the SEC as a BD an advantage over FCMs that are otherwise registered with the SEC. Since most large wire houses and regional firms that handle institutional customers that would qualify as Eligible Contract Participants are both an FCM and a BD, the opt-out provisions of CFTC Rule 1.68 will be nullified by SEC Rule 15c3-3 with respect to their customers that are Eligible Contract Participants. This appears to frustrate the purposes of Congress in attempting to create a level playing field and in mandating opt-out for Eligible Contract Participants trading on DTEFs.

IV. Reporting and Recordkeeping Requirements

Under the CFMA, an FCM or IB that is notice registered as a BD with the SEC would be required to file FOCUS reports with the SEC. The exemption for a notice registered BD in the CFMA from provisions of the 34 Act does not include an exemption under Section 17(a) which requires the filing of a FOCUS report pursuant to SEC Rule 17a(5).[37] However, under the proposed rules under the joint release, Rule 17a-5 would be changed to provide that notice registered BDs would not need to file FOCUS Reports.[38] It appears that a BD notice registered as an FCM or IB would only have to file financial reports with the CFTC.

Both the CFTC and the SEC have risk assessment report filings.[39] The CFMA created a level playing field by exempting FCMs and IBs that are notice registered BDs from the SEC risk assessment reporting regime and by exempting BDs notice registered as FCMs or IBs from the CFTC risk assessment reports.[40]

With respect to recordkeeping, the joint release proposes that SEC rules apply to security futures carried in securities accounts and CFTC rules will apply to security futures carried in futures accounts. However, either regulatory agency may review records with respect to security futures regardless of whether security futures are carried in a securities account or a futures account.

With respect to SEC recordkeeping rule 17a-3,[41] ithe joint release proposes that it would not apply to a notice registered BD and it would not apply to a BD that is also an FCM that holds security futures in a futures account. Rule 17a-4[42] would be amended to provide that the SEC may examine records for any security futures account, even if maintained as a futures account. Rules 17a-7,[43] 17a-11[44] and 17a-13[45] would be amended so that they are not applicable to FCMs or IBs that are notice registered BDs.

V. Capital Requirements

Both the CFTC and the SEC have capital requirements.[46] The CFMA exempts FCMs and IBs notice registered as BDs from certain provisions of the 34 Act including SEC Rule 15c3-1, the SEC capital rule.[47] The CFMA allowing BDs to notice register as an FCM or IB for purposes of trading security futures also exempts notice registered FCMs and IBs from the CFTC capital rule.[48] This treatment preserves the status quo and may not make any difference in some cases, but in other cases it could make a significant difference. Under the CFTC capital rule and under the SEC capital rule, a BD that is an FCM or IB or vice versa is required to have as minimum capital the greater of the capital amount computed according to either of the rules. However, there are some differences in the two rules. Several of these differences continue to frustrate the goal of a level playing field. One of these differences is that the CFTC capital rule does not require a four percent haircut on customer short options.[49] However, the opposite is true under the SEC capital rule.[50] The SEC rule requires a four percent haircut on the market value of commodity options granted by option customers. In some cases, this can be a huge difference. It has and will continue to severely impact the capital of BDs that are FCMs who have customers with short option transactions. It should be noted that there are other differences between the two capital rules. For example, the consolidation provisions and their interpretations for guaranteed subsidiaries and non-guaranteed subsidiaries are different.[51] In the past, the SEC and the CFTC staffs have worked diligently to coordinate their interpretations under their parallel capital rules, each of which incorporates large parts of the other agency's rule for one purpose or another. It would be hoped that these disparate differences would be further ameliorated so that the treatment would conform with the Congressional mandate of equal treatment.

VI. Margining of Security Futures Products

A. The CFMA Requirements

As noted previously, the CFMA provided that the Federal Reserve Board has authority to promulgate rules regarding any extension or maintenance of credit or collection of margin from customers on security futures products.[52] The CFMA also provides that the Federal Reserve Board may delegate such authority to the CFTC and the SEC which will jointly prescribe rules pursuant to the

mandate described below. The Federal Reserve Board has delegated the authority to promulgate regulations to the SEC and CFTC. Knowing the tension between the CFTC and the SEC, Congress in the CFMA wisely provided that in the event that the CFTC and SEC do not agree on prescribed margin rules within a "reasonable period of time" the Federal Reserve Board shall prescribe such regulations pursuant to the criteria set forth in the CFMA. The mandate is to prescribe rules that meet the following criteria:

(i) to preserve the financial integrity of markets trading security futures products;

(ii) to prevent systemic risk;

(iii) to require that –

(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 that nothing in this sub paragraph shall be construed to prevent a national securities exchange or national securities association from requiring higher margin levels for a security future product when it deems such action to be necessary or appropriate; and

(iv) 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).[53]

B. The General Scheme

In a second joint release, the CFTC and the SEC proposed rules with respect to margin and margining of security futures.[54] In the margin release, the CFTC and SEC have jointly proposed new CFTC rules 41.43 through 41.48 and SEC rules 400 through 404. These rules establish a number of principles. The key provisions are as follows:

1. The requirements of Regulation T, other than margin levels, apply to the financial relationships between a creditor (which includes a BD, an FCM or an IB) and a customer with respect to security futures;

2. The time limits for collection of initial and maintenance margin from customers is set at up to three business days;

3. The acceptable collateral for margining a security futures transaction is set forth; and

4. The minimum and initial margin levels required are established for carrying a long or short security futures position at 20% of the current market value of such position subject to certain lower margin for certain offset positions.

C. Regulation T Compliance

Since Regulation T will govern the accounts, FCMs that are notice registered BDs will need to set up a margining system in compliance with Regulation T for security futures. This should be extremely expensive and will not fit with most of the current software that is used by FCMs. Most firms that are fully registered as an FCM and BD have separate accounting and customer systems.

D. Exclusions

The proposed rules cover any BD or member of a national security exchange effecting transactions for customer involving or carrying account involving a security futures. The rules, however, exclude a number of categories.

1. Financial relations between a customer and a BD under a portfolio margining system.

2. Financial relations between a foreign branch of a BD and a foreign person.

3. Margin requirements of clearing agencies such as Option Clearing Corporation ("OCC") or the various clearing houses in the futures industry.

4. Credit extended, maintained or arranged by a BD to or for a member of a national

securities exchange or registered BD involving the following:

a. margin arrangements with an exempted broker as defined under Regulation T.

b. margin arrangements with a borrower otherwise exempt pursuant to §7 of the 34 Act.

c. financial relations between a BD and a member of a national securities exchange or association.

While there is an exemption for portfolio margining, the exemption at this time is somewhat illusory until a satisfactory portfolio margining system is developed and approved. The Commissions would require approval of the portfolio system by both of the Commissions before it would be implemented. The Commissions jointly urge such a development at the earliest possible time, referring with approval to the OCC's theoretical intermarket margining system ("TIMS") and the standard portfolio analysis risk ("SPAN") used currently for traded futures contracts at both the clearing and customer level.

With respect to foreign customers of a foreign branch, there would be an exemption. Likewise, margin requirements imposed by the clearing agencies are not covered. Furthermore, margin arrangements with an exempt borrower pursuant to §7 of the Exchange Act, such as a market maker or specialist, are excluded. It is also proposed that floor traders trading on futures exchanges would be included within that exemption. The same relief would be available for a member of a national securities exchange and a creditor where there is an upstairs trading platform trading security futures.

E. Margin Levels

The rules propose margin levels based upon the CFMA requirements that they be similar to the margin levels for options on securities. The base requirements is proposed at 20% of the "current market value." Current market value is defined as the settlement price *on the day of the transaction* and not the day before as is customary in the futures industry. There is a significant number of margin offsets that are proposed to be allowed, which follow the offsets for securities option trading, a chart of which is included in the proposing release. The proposed rules provide that any market may require its members to meet higher margin levels.

Under the proposed rules, the margin, both initial and maintenance, must be obtained no later than three business days. For purposes of collateral, the proposed rules provide that a customer can satisfy margin requirements by cash, margin securities as defined in Regulation T, exempted securities as defined by the 34 Act, or other collateral permitted under Regulation T. Self-regulatory organizations may propose different margin collateral as long as those requirements are consistent with Regulation T and approved by the SEC. The Release makes clear that security futures are not margin securities. Security futures would be treated the same as a short option and would have no value for margin purposes. The proposed rules also provide a scheme for approval of changes in margin rules by both the CFTC and the SEC.

F. Commentary

The CFTC and the SEC staff faced a Congressional mandate as to the parameters of security futures margining as noted above. These constraints will probably led to higher margining requirements for security futures than necessary to cover the risk. Futures are different than options in many respects. At expiration of an option, the buyer is not required to exercise or take action. Options expire unless exercised. However, at the termination or delivery date of futures, both the seller and buyer must perform. One party must make delivery and the other party must pay for the future. Since both the buyer and seller of a futures contract must perform, they both must continuously margin their performance. An option is different because only the seller must margin performance. The buyer of an option need only pay the premium for the option. Because of these differences, the margins for securities options are significantly higher than margins for futures. Unfortunately, the CFMA, by mandating options margining for security futures has imposed margin requirements on security futures which are in excess of the inherent risk. The so-called level playing field created by Congress may very well result in security futures having little appeal to sophisticated investors who can replicate the product in other ways with less margin.

VII. CFMA Impact on Registration

Today many customers, particularly high net worth individuals and large institutions, use both securities and futures products jointly in their portfolio. To maximize the use of leverage and collateral, high net worth individuals and institutions generally maintain their assets in one account at one clearing broker that is both a BD and FCM so that the collateral for securities accounts may be used for futures accounts and vice versa by appropriate transfers between the particular accounts. This permits a customer to make the most efficient use of its collateral. Furthermore, in many cases it reduces the amount of collateral required because with portfolio margining, the regulatory or house margin will be less since securities positions may offset futures and vice versa from a risk standpoint. With this in

mind, it is unlikely that an FCM that is notice registered as a BD would be able to attract high net worth individuals and institutional customers because the FCM would not be in a position to carry other securities positions which would be needed for hedging, offsetting security futures positions and correspondingly reducing the amount of collateral. Likewise, a BD that is notice registered as an FCM would be handicapped in maintaining an account for a high net worth individual or an institutional customer that wishes to actively use both futures and securities products. Only at a financial service firm that is both an FCM and a BD may a customer use the full range of products for portfolio management with the minimum amount of collateral. There are a number of other obvious advantages of such an account such as reducing transfers and errors. Further, each day the customer will have a summary of all of its positions. This is not a new issue, but what it means is that most BDs need to be FCMs and vice versa if they are to handle high net worth individuals and institutional customers.

VIII. Some Issues Not Addressed by the CFMA

The CFMA and the proposed rules have not addressed the question of give-ups and clearing member transfer agreements ("CTAs") or prime brokerage. Under these arrangements, a firm executes a transaction for a customer and then transfers the transaction pursuant to the agreements to a clearing firm which clears the transaction and holds the customer's positions and funds. The industry needs to rapidly address the issue of give-ups, prime brokerage and CMTA transactions for security futures positions.

The issue of cross-margining between futures and securities products is also not a new issue, but with security futures there will be a new impetus to have cross-margining between securities and futures products. Under the current regime, BDs that are FCMs are required by customer needs to be members of the clearing houses of a number of futures exchanges as well as members of a number of the securities clearing organizations such as OCC, National Securities Clearing Corporation, and the Government Securities Clearing Corporation. Further, many firms need to be members of foreign clearing houses or organizations. The BD FCMs that are members of numerous clearing organizations are required to post unnecessary collateral because even though positions held at different clearing organizations offset each other economically, they are not carried in the same clearing system and have to be margined separately without taking into consideration the offsets available for a product cleared in another system. Cross-margining and clearing house interfaces not only with respect to security futures but also other products will be issues that need to be addressed rapidly in the future.

As explained with respect to margining, the margin requirements are very high for a futures product. As explained above, both the SEC and CFTC endorse portfolio margining which could result in significant reduction in margin levels for offset positions. The current offset positions follow option offsets and are certainly not generous in order they probably do not take into consideration the real risk in a number of portfolios. For this reason, the industry to be competitive globally must move rapidly to portfolio margining of security futures in addition to the current portfolio margining of futures products. The SEC rules and the CFTC rules both provide that the account statements to be sent to customers follows the type of account.[55] Confirmations are required to follow the requirements of the account in which they are held.

IX. Conclusions

A. CFMA Issues Regarding Regulatory Conflicts

As discussed above, Congress tried to level the playing field between BDs, FCMs and IBs with respect to security futures. However, as noted above, anomalies and differences persist.

Unfortunately, the CFMA, by mandating options margin for security futures, has imposed margin requirements on security futures which may be in excess of the inherent risk. Congress appears to have ignored continuous margining by both the buyer and the seller in the case of a futures contract. The United States margining requirements for security futures will also be significantly higher than security futures in the offshore markets. As a result, the United States markets for security futures may have a difficult time competing. Large international institutions may well deal with offshore security futures markets, such as the London International Financial Futures and Options Exchange if it offers security futures for major international securities. This presents an opportunity for foreign markets to develop and dominate the security futures markets. Once developed with liquidity and volume, it will be virtually impossible for the United States markets trading security futures to compete. In the future, there may be very little, if anything, for the United States regulators to regulate. Of course, the United States regulators might decide to bar foreign security futures from the United States but this would create a significant reverse impact barring many other United States markets and products from other countries. Congress should clearly revisit the mandate of the CFMA with respect to margining.

B. The Global Perspective

Both the CFMA and the Financial Modernization Act, the Gramm-Leach-Bliley Act of 2000, (the "GLB"),[56] have reduced numerous jurisdictional conflicts. Nevertheless, there are many problems yet to be resolved. The two Acts were clearly a step in the right direction. They will assist the

United States financial service industry and derivative businesses to compete globally. Unfortunately, the CFMA and GLB did not go far enough in resolving many of the petty rivalries among the CFTC, the SEC and banking industry regulators. All who have worked with the CFMA will agree that it is not a model of legislative draftsmanship. However, if Congress had waited for the appropriate legal draftsmanship, the CFMA may never have seen the light of day. Nevertheless, the CFMA is a major step forward for the United States securities, futures and banking industries that have been divided by jurisdictional conflicts over derivative products. Although the United States financial service industry will be more competitive worldwide as a result of the two acts, both of them leave a lot to be desired and competitive impediments and jurisdictional conflicts remain.

Further, capital rules and client asset segregation within the United States, such as the SEC and CFTC and Federal Reserve Board capital requirements are not harmonized. While the SEC and CFTC capital rules are close, further work should be done. One of the major impediments to harmonization of financial responsibility rules in the United States is different bankruptcy regimes for different types of financial service firms. Banks have one regime, BDs have another and FCMs have a third. Until these are reconciled, we will have conflicts in the United States regarding capital and customer fund protection. If the United States wishes to remain a global financial player, its financial services industries must move to a common bankruptcy regime, and then common financial responsibility rules for all types of financial services firms. The United States should do this quickly and move forward as an example to other nations.

Jurisdictional conflicts by their very nature create capital issues and other impediments that impair the ability of the United States financial service entities to operate worldwide. Lack of harmonization of the SEC, CFTC and bank capital rules with that of European and other countries often result in United States firms being unable to operate without a subsidiary in the foreign country. For example, SEC Rule 15c3-3 as interpreted by the SEC applies to all foreign customers. This is not an unreasonable position since the Securities Investors Protection Act[57] would appear to apply to them. However, when the requirement of SEC Rule 15c3-3 reserve deposits conflicts with client money rules of foreign jurisdictions, it results in chaos. In such cases, the financial service firm may be required to maintain a reserve segregated account not only for the client money in the foreign jurisdiction, but also an account with an equal amount of money in the United States. This requires the firm to use its own money to fund one of the two accounts to cover the same risk. This double counting is a huge drain on the capital of United States financial service firms that would like to operate worldwide and use a single capital base. Double counting can be avoided by using a subsidiary, but the subsidiary would need to be capitalized. Splitting the capital between two entities and reducing the total amount of capital available to each entity reduces the ability of the firm to operate and to effect large transactions safely. This split use of capital is counterproductive, inefficient and undermines the United States entities competitive position. This double counting also virtually prohibits many European firms from being directly able to operate in the United States and they too must use subsidiaries that result in a less efficient use of capital.

To have truly global competition, there are a number of rules in the capital and margin area that need reconciliation between the legal regimes of various countries. In the first place, the bankruptcy laws drive the financial responsibility, client asset segregation and similar rules. The bankruptcy laws of countries are inconsistent and without more consistency, it will be more difficult to reach harmonization of capital and financial responsibility rules between the regulators of various countries. Without reconciliation of the different bankruptcy regimes between the SEC, the CFTC and banking industry, the United States is hardly in a position to argue for international harmonization of bankruptcy regimes. To its credit, the European Union ("EU") is attempting to harmonize bankruptcy provisions with respect to financial service participants among the various members of the EU. If the EU is able to reconcile its bankruptcy regime, it would be a major step forward for their financial service industries. Such a regime would also drive the financial regulators to a single segregated client money rule and capital rule. It would make those financial service firms much more competitive.

Some steps with respect to harmonization of capital rules have been undertaken. The Basel Capital Accord and the International Organization of Securities Commissioners are steps in the right direction, but these will be hampered until there is a common bankruptcy provision among the leading financial service countries.

With respect to margining, most financial service regulators are moving in the direction of risk-based portfolio margining for firms as well as for their customers. The United States needs to continue to move in that direction and harmonize risk-based portfolio margining between not only the CFTC and the SEC, but the other financial regulators. The United States should then take the lead internationally. All in all, progress has been made and the CFMA and GLB are steps in the right direction, but far more work needs to be done both within the United States and internationally to harmonize bankruptcy regimes, financial service firms, financial responsibility, client money protection and margining. ■

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 34 Act §6(g), 15 U.S.C. §78f(g).
9 9 CEA §5f, 7 U.S.C. 7(b).
10 34 Act §15(b)(11)A, 15 U.S.C. §78o(b)(11)(A).
11 CEA §4f(a), 7 U.S.C. §6f(a).
12 34 Act §15b(11)B, 15 U.S.C. §78o(b)(11)(B).
13 34 Act §15A(k), 15 U.S.C. oA(k).
14 CEA §4f(a)(4)(A), 7 U.S.C. §5f(a)(4)(A).
15 CEA §4f(a)(4)(A), U.S.C. 6f(a)(4)(A).
16 34 Act §15(b)(11)(B), 15 U.S.C. §78o(b)(11)(B).
17 CEA §4f(a)(4)(A), 7 U.S.C. §6f(a)(4)(A).
18 34 Act §7(c)(2), 15 U.S.C. §78g(c)(2).
19 *See* CEA §4d, 7 U.S.C. 6d; *See also* Rule 120 *et seq.*, 17 C.F.R. 1.20 *et seq.*; Rule 30.7, 17 C.F.R. 30.7.
20 34 Act §15(c)(3), 15 U.S.C. §78o(c)(3); 17 C.F.R. 240.15c3-3.
21 15 U.S.C. §78o(c)(3).
22 Securities Investors Protection Act of 1970 §3(o)(2)(A); 15 U.S.C. §78ccc(i)(a)(A).
23 CEA §4f(a)(4)(A), 7 U.S.C. §6f(a)(4)(A); *See* CFTC Rule 1.20, *et seq.*, 17 C.F.R. 1.20 and Rule 30.7, 17 C.F.R. 30.7.
24 Release No. 34-44854 (September 25, 2001).
25 17 C.F.R. 1.55.
26 17 C.F.R. 240.15c3-3.
27 7 U.S.C. §6(d).
28 CEA §5a, 7 U.S.C. §7a.
29 CEA §1(a)(12), 7 U.S.C. §1a(12).
30 CEA §5a(f), 7 U.S.C. §7a(f).
31 17 C.F.R. 1.68.
32 Rule 1.17(a)(1)(i).
33 66 F.R. 20740 at p. 20741 (April 25, 2001).
34 *See* NYSE Interpretation Handbook, p. 624, item /02; SEC Release 34-9922 (January 2, 1973).
35 NYSE Interpretation Guide, p. 624, item /021 SEC Staff to NYSE (May 1978).
36 NYSE Interpretation Guide, p. 624, item /022; NYSE Information Memo (April 20, 1988).
37 34 Act §17a, 15 U.S.C. §78q(a); SEC Rule 17a-5, 17 C.F.R. 17a-5.
38 Release No. 34-44854 (September 25, 2001).
39 34 Act §17(h), 15 U.S.C. §78q(h); CEA §4f(c), 7 U.S.C. §6f(c). *See, also* SEC Rules 17h-1 and 17h-2, 17 C.F.R. §240.17h-1 & 2; *see, also* CFTC Rule 1.14, 17 C.F.R. 1.14.
40 34 Act §15(b)(11)(B), 15 U.S.C. §78o(b)(11)(B); CEA §6f(a), 15 U.S.C. §7f(a).
41 17 C.F.R. 240.17a-3.
42 17 C.F.R. 240.17a-4.
43 17 C.F.R. 240.17a-7.
44 17 C.F.R. 240.17a-11.
45 17 C.F.R. 240.17a-13.
46 *See* CFTC Rule 1.17, 17 C.F.R. 1.17; SEC Rule 15c3-1, 17 C.F.R. 240.15c3-1.
47 17 C.F.R. 240.15c3-1.
48 CEA §4f(a)(4)(A).
49 CFTC Rule 1.17(c)(5)(iii), 17 C.F.R. 1.17(c)(5)(iii).
50 SEC Rule 15c3-1b(3)(x), 17 C.F.R. 240.15c3-1(b)(3)(x).
51 Compare SEC Rule 15c3-1c, 17 C.F.R. 240.15c3-1(c) with CFTC Rule 1.17(f), 17 C.F.R. 1.17(f).
52 34 Act §7(c)(2), 15 U.S.C. §78g(c)(2).
53 34 Act §7(c)(3)(B), 15 U.S.C. §78g(c)(3)(B) (emphasis added).
54 SEC Release No. 34-44853 (September 25, 2001).
55 17 C.F.R. 1.33a.
56 Public Law 106-102, 113 Stat. 1338 (November 12, 1999).
57 15 U.S.C. §78ccc *et seq.*

SEC and CFTC Regulation of Investment Funds and Their Managers: Convergence, Inconsistency, and Open Issues

by Emily M. Zeigler

United States regulation of investment funds and their managers is complex and far-reaching. In many cases, investment funds and their managers are subject to regulation under the Investment Company Act of 1940 (the "ICA"), the Investment Advisers Act of 1940 (the "IAA"), the Securities Act of 1933 (the "1933 Act"), the Securities Exchange Act of 1934 (the "1934 Act") and the Commodity Exchange Act (the "CEA"). Some funds and managers are also subject to federal employee-benefit and banking laws, as well as state laws including those governing securities, commodities and insurance. This convergence of regulations with respect to a single product and industry provides a myriad of safeguards for investors, but also a myriad of rules for professionals that are often duplicative or inconsistent. This article highlights the basic areas of overlapping regulation of investment funds and managers by the Securities and Exchange Commission ("SEC") under the ICA, the IAA, the 1933 Act and the 1934 Act and by the Commodity Futures Trading Commission ("CFTC") under the CEA, and emphasizes some inconsistencies and open issues that exist in those areas.

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