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SEC/CFTC Report On Harmonization Of Regulation And How It May Affect Investment Advisers

On October 16, 2009, the Securities and Exchange Commission (SEC) and the Commodity Futures Trading Commission (CFTC) issued **"A Joint Report of the SEC and the CFTC on Harmonization of Regulation"** (Report). The Report was issued in response to the Administration White Paper on Financial Regulatory Reform, which requested the SEC and the CFTC to identify "all existing conflicts in statutes and regulations with respect to similar types of financial instruments and either explain why those differences are essential to achieve underlying policy objectives with respect to investor protection, market integrity, and price transparency or make recommendations for changes to statutes and regulations that would eliminate the differences." [1] As part of the process, the agencies held unprecedented joint meetings on September 2 and 3, 2009, with the participation of all nine sitting Commissioners of the two agencies. Thirty panelists, consisting of members of the investor community, academics, industry experts, and market participants, assisted the agencies in defining the issues of greatest concern, and explored topics ranging from exchange, markets, and clearing issues, to regulation of intermediaries and end-users, to enforcement.

The Report contains 20 recommendations. Twelve of the recommendations would require new legislation, some of which has already been proposed. Another four recommendations address process issues, such as establishing joint task forces on enforcement and information technology, and cross-training of agency staff and providing for detailing of staff between agencies. The remaining four recommendations may be implemented under existing authority.

This Alert will focus upon the recommendations in the Report that may be of greatest interest to investment advisers: (1) the potential "uniform" standards of "fiduciary" duties for persons providing investment and commodity trading advice for securities and futures; (2) aiding and abetting liability under the Securities Act and the Investment Company Act; and (3) aligning the reporting requirements for private funds. The Alert also discusses the other recommendations, some of which may indicate a greater openness to international access for investors, enhanced opportunities for portfolio margining across markets, and the prospect of greater clarity and expedited judicial review of new products that straddle jurisdictional lines.

[1] Financial Regulatory Reform – A New Foundation: Rebuilding Financial Supervision and Regulation (June 17, 2009) at 50-51, available at http://www.financialstability.gov/docs/regs/FinalReport_web.pdf.

Investment And Commodity Trading Advisory Services

The sixth recommendation in the Report states that there should be *"legislation that would impose a uniform fiduciary duty on intermediaries who provide similar investment advisory services regarding futures or securities."* [2] The agencies recommend that a consistent standard apply to commodity trading advisors (CTAs), futures commission merchants (FCM), commodity introducing brokers (IBs), broker-dealers (BDs), or investment advisers (IAs) that provide similar personalized investment and commodity trading advisory services. The Report does not limit this recommendation to registered entities, so presumably commodity pool operators (CPOs) that are exempt from registration as a CTA because they only advise pools that they operate also would be subject to the new fiduciary standard. However, it does not appear that the recommendations seek to apply fiduciary duty standards to CTAs and IAs that provide only non-personalized advice.[3]

Currently, as the Report points out, neither the Commodity Exchange Act (CEA) nor the CFTC's regulations explicitly establish "fiduciary" obligations. The Report states that IAs are considered fiduciaries under the SEC's regulatory regime, but the Report also notes that various court cases recognize that the extent to which BDs, CTAs, CPOs and FCMs may have fiduciary duties can vary under state common law that will turn on specific factual circumstances.

There have been attempts in the past to extend certain regulatory requirements applicable to CTAs, such as providing disclosure documents to prospective clients, to FCMs that operate in-house managed futures account programs. These efforts have been abandoned in response to FCM arguments that these additional requirements are unnecessary because FCMs are required to meet minimum financial requirements that are not applicable to CTAs, and because FCMs tend to have more sophisticated and highly structured supervisory procedures than CTAs. FCMs can be expected to make similar arguments against any new duties being imposed upon them, and it will be interesting to see if such arguments are convincing enough to legislators to sustain the current standards.

Aiding And Abetting Liability

Another recommendation for legislative action is to add specific statutory proscriptions against aiding and abetting violations of the Securities Act and the Investment Company Act, which would expand SEC enforcement authority to prosecute persons for aiding and abetting such violations. The CEA already contains specific proscriptions against aiding and abetting any violations of that statute and CFTC regulations.

Reporting And Recordkeeping Requirements

One recommendation of the Report that would not require new legislative authority is the recommendation to align specific private fund reporting and recordkeeping requirements. The Report states that the CFTC and the SEC should review regulatory requirements applicable to IAs and CTAs/CPOs with respect to private funds to eliminate, as appropriate, any inconsistent or conflicting provisions regarding: (i) the use of performance track records; (ii) requirements applicable to investor reports (including the financial statements often used by registered IAs to comply with the Advisers Act custody rule and the financial statements delivered to investors by CPOs); and (iii) recordkeeping requirements. Because the agencies would not have to wait for legislative action to implement this recommendation, any necessary amendments to harmonize regulations could proceed on the agencies' own schedules. As far as recordkeeping requirements are concerned, the Report separately calls for harmonization of all recordkeeping requirements between the CFTC and SEC. The Advisers Act Rule 204-2 generally specifies a five-year retention period, the first two in the office of an adviser. The CFTC recordkeeping retention regulation requires five-year retention for all records, and CPOs and CTAs must maintain records in their main office. It would appear that these

[2] Report at 90.

[3] Advisers that provide only non-personalized advice are not considered to be fiduciaries. *See Lowe v. SEC*, 472 U.S. 181 (1985); *see also* CFTC Regulation 4.14(a)(9) (exempting such advisers from registration under the CEA). However, these advisers would still be subject to general antifraud proscriptions and restrictions on advertising.

provisions can be easily harmonized. The Report did not address requirements for publicly traded funds.

International Trading

Regulatory standards applicable to international trading is another area where no new legislation would be needed to implement the agencies' harmonization objectives. The Report recommends that the SEC review its approach to cross-border access to determine whether greater efficiencies could be achieved for cross-border securities transactions consistent with investor protection and the public interest. The Report notes that the CFTC has provided greater openness for U.S.-located persons to trade on non-U.S. markets and through non-U.S. intermediaries, under a number of exemptions provided in accordance with Part 30 of the CFTC's regulations, than the SEC has permitted for U.S.-located securities investors.

The CFTC Part 30 regulations have been in place for over 20 years and the CFTC has found few, if any, customer protection issues concerning transactions on non-U.S. futures markets by U.S.-located customers. The SEC may be able to benefit from the CFTC's experience in the international arena in order to establish a model similar to the CFTC's Part 30 regulations. The Report indicates that the SEC could consider limited revisions to SEC Rule 15a-6, which governs the interaction of U.S. investors with foreign broker-dealers. Industry participants have suggested that the SEC could also reconsider its stance on products traded on non-U.S. markets, particularly security futures products. The SEC only recently, and after some prodding from Congress, permitted limited trading in security futures products outside the U.S. by "qualified institutional buyers" and non-U.S. persons, as explained in an earlier Alert. Nonetheless, the idea of mutual recognition has engendered considerable opposition, and Chairman Schapiro has signalled that she will move slowly, if at all, in this area.

The Report goes in the other direction, however, when it recommends legislation to empower the CFTC to require foreign boards of trade (FBOT) to register with the CFTC. This recommendation is consistent with provisions in Title VII of the Administration's proposed financial regulatory reform legislation. The CFTC has had in place for over a decade a "no-action" procedure whereby members of FBOTs located in the U.S. can have direct access to the FBOT's trading facility to trade on their own behalf. This again has proven to be an area free of investor complaints. In recent years, some of the no-action relief has also permitted FBOT member CPOs and CTAs to trade on behalf of commodity pools or managed accounts, under certain conditions. The CFTC has considered adopting regulations in this area, but has refrained from doing so and maintained the no-action process because of some difficult definitional issues and a concern about the measures international regulators might be prompted to take regarding the rights of U.S. exchanges to offer access to their trading facilities from within their countries, if the U.S. required licensing of FBOTs. The current CFTC approach of cross-border recognition and denomination of a lead international regulator for each FBOT, with appropriate information sharing arrangements and processes for customer redress, has worked well to date and could serve as a general model across the globe and among all financial markets.

Portfolio Margining

There was a great deal of discussion at the September meetings about portfolio margining, a process whereby customer margin requirements would be based upon a risk assessment across the customer's entire portfolio of futures and securities products. Where customers hold related positions across markets that are risk reducing when examined together, margin requirements could be reduced appropriately and capital could be freed up for other uses. The CFTC and SEC would support legislation that confers upon customers the choice of portfolio margining in a single futures or securities account at a dually registered BD/FCM, which is similar to the way security futures are handled now, provided the firm offers customers a choice of type of account. Specifically, the Commissions would support legislation that: (i) clarifies that security options, security futures products (SFPs), and certain other securities derivatives may be held in a futures account and that, in the event of the firm's insolvency, customer claims would not be protected under the Securities Investor Protection Act (SIPA), but would be resolved under the futures insolvency regime; (ii) clarifies that futures may be held in securities

portfolio margin accounts and that the CFTC may waive its segregation requirements with respect to such futures; and (iii) extends SIPA protection to customer claims based on any futures and options on futures (and certain other securities-based derivatives) held in a securities portfolio margin account, together with the collateral held to margin those positions. Such an approach may increase SIPC premiums charged to dually registered firms, which may be passed on to customers, but this could provide customers with greater choice than is now the case regarding how their positions and funds are held and treated in a bankruptcy.

The Commissions acknowledge that industry participants are currently developing different approaches to achieving the benefits of portfolio margining, including the two account ("two pot") model. The Report recommends that the CFTC and SEC should undertake to review their existing customer protection, margin and other relevant regulations to determine whether any changes or exemptive relief would be necessary to achieve the full benefits of risk-based portfolio margining. The Report further recommends that the Commissions undertake, with input from experts, the industry, and the public, to study whether further modifications to portfolio margining, including adoption of a one account ("one pot") model that would accommodate all financial instruments and all BDs and FCMs, would be in the public interest.

Novel New Products

The Report recommends that Congress enact legislation that would provide a process for expedited judicial review of jurisdictional disputes between the agencies regarding new products. In a Memorandum of Understanding (MOU) between the CFTC and SEC dated March 11, 2008, the Commissions "acknowledge that there may be instances in which novel derivative products may reflect elements of both securities and commodity futures or options." Accordingly, the SEC and the CFTC support legislation that is designed to create: (i) greater legal certainty with respect to product listings and the agencies' use of exemptive authority; and (ii) a review process for jurisdictional disputes that includes a firm timeline.

Specifically, the SEC and CFTC would support legislation that permits: (i) the CFTC to exercise jurisdiction over an instrument that the SEC exempts, conditionally or unconditionally, pursuant to its authority under the Securities Exchange Act; and (ii) the SEC to exercise jurisdiction over a securities-related instrument that the CFTC has exempted pursuant to its authority under the CEA. The CFTC and the SEC would support legislation that establishes a time-frame and process along the following lines: (a) if either agency receives an application for listing of a novel derivative product that may have elements of both securities and commodity futures or options, agency staff shall immediately notify the other agency's Secretary and forward a copy of such application; (b) upon a request by the Chairman or Commission of either agency, the other agency's Commission shall, within 120 days of such request, by order determine whether the Commission intends to assert jurisdiction; and (c) if one agency does not agree with the other agency's determination regarding the status of a product, it may petition a U.S. Court of Appeals for expedited review.

A new spirit of cooperation between the CFTC and SEC reflected in the Report might suggest a lesser likelihood of jurisdictional squabbles between the agencies. However, there will undoubtedly be close cases in the future, as the 2008 MOU recognized. It must also be kept in mind that the agencies are not the sole stakeholders in such cases. The tough cases will be presented by parties that are seeking to bring innovative, profitable products to market, who may have their own interests and preferences for where and how trading takes place. If the expert agencies are unable to agree on how to regulate a product, it is hard to see how a U.S. Court of Appeals could be expected to resolve the matter on an expedited basis. Nonetheless, the two Commissions seem to prefer a judicial resolution to their disputes to the approach proposed by the Administration, under which an office in the Treasury Department would be responsible for resolving such disputes.

Other Recommendations

Joint information technology task force. The other recommendations in the Report generally relate to agency authority and processes for cooperation between the CFTC and SEC. For example, the last recommendation in the Report is that the agencies develop a Joint Information Technology Task Force to pursue linking

information on regulated persons and such other information as the agencies jointly find useful and appropriate to make available to the public. The Report states that "[t]he task force should also explore linking or coordinating the NFA BASIC[4] database and IARD,[5] which would make it easier for investors and customers to find registration and disciplinary information for an adviser."

Review of exchange and clearing organization rules. Another recommendation is for legislation that would increase CFTC's authority over exchange and clearing organization compliance with the CEA. This recommendation would extend the time for CFTC review of new and amended rules or products proposed by an exchange or clearing organization from one to ten business days, with a possible extension of another 90 days for novel or complex rules or products or in other circumstances. This recommendation also is embodied in Title VII of the Administration's proposed financial regulatory reform legislation. If such a proposal were adopted, it might provide an opportunity for advisers, trade associations and others to comment upon rules or products that may have substantial competitive impact before they are made effective by exchanges or clearing organizations. Because advisers are generally not members of exchanges or clearing organizations, advisers and their trade organizations may not now have much opportunity to influence the development of new rules and products of exchanges and clearing organizations. As would be expected, exchanges and clearing organizations in both the futures and securities arenas have opposed the recommendation, expressing support instead for the existing framework, and encouraged the SEC to permit greater use of "effective on filing" status. The futures markets viewed the self-certification process as one of the major accomplishments of the Commodity Futures Modernization Act of 2000, so they can be expected to resist efforts that may, in their view, "turn back the clock" on the rule and product approval process.

[4] The acronym BASIC stands for Background Affiliation Status Information Center, which was developed and is operated by the National Futures Association, NFA.

[5] The acronym IARD stands for Investment Adviser Registration Depository, which was developed and is operated by the Financial Industry Regulatory Authority, FINRA.

Adviser risk disclosure. The agencies recommend that there be greater consistency in IA and CTA customer risk disclosure statements. At the September meetings, a panelist contrasted the CFTC and SEC disclosure documents, noting that, whereas the former is between two to three pages, the latter can be over 100 pages. The CFTC's disclosure documents were thus cited as a model to follow because of their brevity and accessibility. The Report states that the SEC intends to review the current Options Disclosure Document (ODD) to determine whether a customer disclosure document more akin to that used for futures products would be appropriate and consistent with the protection of investors and the public interest. As noted above, there is a separate recommendation to align private fund recordkeeping and reporting requirements.

Whistleblowers. The Report recommends legislation to encourage whistleblowers to come forward with relevant information to the SEC and CFTC, which should provide for (1) rewards for legitimate whistleblowing, and (2) protection of whistleblowers. This recommendation is consistent with Title IX of the Administration's proposed financial regulatory reform legislation.

Commodity trading conflict of interest procedures. The Report also recommends legislation to expand the CFTC's authority concerning conflicts of interest, which would authorize the CFTC to require FCMs and IBs to implement conflict of interest procedures that would separate persons in a firm engaged in research or analysis of commodity prices from those involved in trading or clearing activities. Provisions for such change, patterned on those enacted for securities firms in Sarbanes-Oxley, are part of Title VII of the Administration's proposed financial regulatory reform legislation. Such procedures may be difficult to enforce at those IBs with few employees, so accommodations may need to be made depending upon the size and nature of the enterprise.

CEA enforcement process and manipulation claims. Three recommendations would enhance aspects of the CFTC enforcement program and all would require legislation. One recommendation is for legislation to clarify that restitution imposed in CFTC civil enforcement actions is defined in terms

of the losses sustained by persons as a result of the unlawful conduct. This would harmonize CFTC restitution authority in enforcement actions in federal courts with the restitution authority that the CEA now provides in administrative proceedings.

Another recommendation is to expand the scope of the insider trading prohibition under the CEA to make unlawful the misappropriation and trading on the basis of material, non-public information from any governmental authority. The Report states that currently, for example, it is not unlawful to trade in the futures markets through the misuse of non-public information from many government agencies, including the Federal Reserve, the Treasury Department, the Department of Agriculture and other government bodies. [6]

The other legislative recommendation is to enhance the CFTC's enforcement authority with respect to the ability to prosecute unspecified "disruptive practices" that undermine market integrity and the price formation process in the futures markets. The Report is quite vague on this point. The CEA currently provides proscriptions against "manipulation," "attempted manipulation," "wash sales," "fictitious sales" and "accommodation" trades, but provides no definitions of the conduct covered by these proscriptions. There was some discussion at the September meetings about the difficulties of proving manipulation, and whether the "intent" standard that the CFTC must meet should be broadened to include "reckless" behavior as well, but what is contemplated by that is unclear. The standard for recklessness under the securities laws relates to intent to deceive and defraud. Separate legislation has been introduced to change the legal standard for manipulation under the CEA to bring it into line with SEC, Federal Energy Regulatory Commission and Federal Trade Commission standards that also apply in certain respects to commodity trading. [7] The Report does not identify what "disruptive" practices need to be proscribed.

Inter-agency cooperation. Finally, there are several recommendations for inter-agency cooperation. These include (1) a Joint Agency Enforcement Task Force, (2) cross-training of CFTC and SEC staff, particularly with respect to enforcement and investigations, and (3) staff details to the other agency, mostly in the non-enforcement areas. In addition, the Report recommends legislation to authorize the SEC and the CFTC to jointly form, fund, and operate a Joint Advisory Committee that would be tasked with considering and developing solutions to emerging and ongoing issues of common interest in the futures and securities markets. Members would include both SEC and CFTC members, as well as experts and industry participants.

Conclusion

The Report contains many recommendations for changes to the SEC and CFTC statutory and regulatory frameworks. Most of these require new legislation, some of which has already been proposed, rather than simply action by the CFTC and/or the SEC. This Report may point the way to greater cooperation and coordination between the agencies, and it suggests that the agencies believe there is already a great deal of harmonization between their regulatory frameworks and that the differences that remain are largely due to the differences in the purposes of the various financial markets.

[6] This provision has been referred to as the "Eddie Murphy" rule, because, in the movie "Trading Places" starring Mr. Murphy, part of the plot revolved around trading in the futures market based upon a purloined copy of a Department of Agriculture report ahead of its public release.

[7] *See* S. 1682, introduced by Senator Cantwell on September 17, 2009, and co-sponsored by Senators Dorgan, Feinstein, and Nelson (Florida), which has been referred to the Senate Committee on Agriculture, Nutrition and Forestry.

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