TESTIMONY OF THE SECURITIES INDUSTRY ASSOCIATION

ON

EXAMINING THE COMMODITY FUTURES MODERNIZATION ACT OF 2000 AND RECENT MARKET DEVELOPMENTS

COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS

UNITED STATES SENATE

SEPTEMBER 8, 2005

The Securities Industry Association[1] appreciates the opportunity to testify on *The Commodity Exchange Reauthorization Act of 2005* (S. 1566). We commend the Committee for your interest in provisions of S. 1566 that are of significant importance to the securities industry.

OVERVIEW

SIA strongly supports reauthorization of the Commodity Futures Trading Commission (CFTC) in 2005, but we oppose the provisions of S. 1566 that go beyond CFTC reauthorization and would amend the *Commodity Exchange Act* (CEA) and the recently enacted modifications to the CEA codified in the *Commodity Futures Modernization Act of 2000* (CFMA). The CFMA enjoyed strong bipartisan support in this Committee and in Congress, and it was well received in the public and private sectors. In addition to codifying important modernizing amendments to the CEA, the CFMA brought much needed legal certainty to the U.S. over-the-counter (OTC) derivatives markets and provided a statutory framework that has enhanced the competitiveness of U.S. listed and OTC derivatives markets. Strong U.S. derivatives markets have, in turn, brought important benefits to all sectors of the U.S. economy since enactment of the CFMA. Importantly, the CFMA also established a dual statutory and regulatory framework for the trading of security futures, a class of financial instruments that had previously been prohibited in the United States.

SIA is deeply concerned with two principal areas in S. 1566: 1) provisions addressing the margining of security futures and the status of certain security index futures; and, 2) the scope of language addressing the so-called Zelener decision and related foreign exchange issues, including the provisions to limit the scope of permissible activities of broker-dealers.

In relation to security futures, SIA supports agency rulemakings and SRO rule approvals under the CEA and the *Securities Exchange Act of 1934* (Exchange Act) that would promote U.S. investor access to a broader range of security futures index products and that would encourage the adoption of portfolio margining. However, SIA believes it is essential that any portfolio margining legislation ensure that *all* financial instruments, including stocks, convertible and equity-linked debt, options, and security and security index futures, be included in a manner that does not establish margin-based competitive disparities. SIA opposes the provisions of S. 1566 that are addressed solely to portfolio margining for security futures.

We understand that retail fraud in connection with speculative foreign exchange activities continues to be problematic, as it was prior to enactment of the CFMA. We do not agree, however, with the assertion that there is a compelling need for modifications to the CEA to address these problems. SIA strongly supports efforts to root out fraud against retail investors, but we believe the provisions of S. 1566 are overly broad and could well give rise to unintended adverse consequences.

DISCUSSION

Portfolio Margining

The margin requirements for securities and securities derivatives limit the amount of economic leverage that can be achieved in connection with an investor's position in securities or other financial instruments.

Generally speaking, the margin requirements applicable to broker-dealers in connection with securities and securities derivatives are established under Regulation T of the Board of Governors of the Federal Reserve System (FRB) and under rules adopted by exchanges and other self-regulatory organizations (SROs) and approved by the Securities and Exchange Commission (SEC). In the case of security futures, CEA and Exchange Act provisions also require that security futures margin levels not be lower than the lowest margin requirements applicable to comparable stock options. This latter restriction was adopted in the CFMA to prevent competitive disparities from arising from the application of the margin levels typically required for futures contracts (which are generally lower than those applicable to stocks and stock options).

Today's investment portfolios are increasingly comprised of a wide array of securities and securities derivatives. These positions often have offsetting risk exposures. Under a strict application of the margin rules – without any recognition of the impact of multiple positions on the effective net exposures within a portfolio – the aggregate amount of margin that would be required to be maintained would be equal to the sum of the margin requirements applicable to each individual position.

As a result, the aggregate margin requirements applicable to these portfolios do not reflect the risk-mitigating impact of offsetting positions, thereby leading to over-margining, portfolio inefficiencies, and a misalignment of margin and risk-management incentives. Investors are not incentivized under this approach to engage in risk-mitigating strategies. Excessive margin requirements also impair the competitive position of U.S. brokerage firms competing with non-U.S. financial service firms for the business of foreign customers.

In order to ameliorate these effects, SROs have adopted rules that recognize certain offsetting positions by reducing the aggregate margin requirements applicable to certain specified position combinations. While these so-called “strategy-based” margin levels provide some relief, they do not comprehensively take into account the exposure offsets found in common portfolios of multiple instruments. This is because they do not take into account all of the types of products and product combinations that may comprise a portfolio and give rise to offsetting exposures.

In recognition of the superiority of portfolio margining as an efficient but prudential means of determining margin requirements, the FRB adopted an amendment to Regulation T in 1998 to provide an exemption for any portfolio margining system permitted by an SRO pursuant to SEC-approved rules.[2]

An *ad hoc* committee of SIA has been working with SROs and the SEC for several years to expand the use of portfolio margining, and we have made modest, incremental progress during that time. Importantly, regulators have become increasingly familiar with the tools and techniques associated with portfolio margining, and we are hopeful that in the near future considerably greater progress will be made. SIA’s portfolio margining committee recently submitted the outline of a proposal to the New York Stock Exchange that, if adopted and approved by the SEC, would be an important step in a process ultimately leading to a system of portfolio margining that encompasses the full range of securities and securities derivatives.

Indeed, SIA strongly supports the use of portfolio margining and believes that it should be available for all statistically correlated portfolio positions, all market participants whose positions are subject to federal margin regulation, and all accounts, with the following two stipulations.

First, portfolio-margining arrangements should encompass and provide parity of treatment for all statistically correlated portfolio positions. Portfolio margining should not be available selectively to certain product categories, but not others, in a manner that might produce a potentially anticompetitive result. Ideally, firms would be permitted to use proprietary models for the purpose of calculating portfolio margin requirements.

Second, any portfolio-margining arrangements should be limited to arrangements that do not give rise to uncertainty as to the availability of deposited margin to satisfy outstanding obligations in the case of insolvency of the carrying firm or its customer.

Thus, SIA strongly supports regulatory initiatives designed to facilitate and promote portfolio margining on a comprehensive basis. Similarly, we would support legislation that encourages SEC and CFTC initiatives to approve SRO rules or to adopt rules implementing portfolio-margining systems consistent with the parameters articulated above.

SIA opposes, however, the portfolio margining provisions currently contained in S. 1566. These provisions, among other deficiencies, are too narrowly drawn and have the potential to create inappropriate competitive disparities across competing product markets. SIA also believes, as a general matter, that the nature of the issues presented by portfolio margining are better suited to resolution through the cooperative interaction of the industry, SROs and federal agencies, rather than through a prescriptive legislative approach.

Security Futures Index Definitions

Derivatives on security indices have provided valuable financial tools for the investment community, including retail, institutional, and professional investors. Limitations on investor access to these products arise under the dual regulatory framework for security futures products principally in two contexts: foreign securities and narrow-based security indices and domestic non-equity indices.[3] The current regime also limits the ability of U.S. brokerage firms to compete with non-U.S. financial services firms in offering transaction execution services to foreign customers trading in futures on foreign securities and narrow-based security indices.

Access to these products requires the cooperative action of the SEC and CFTC. SIA strongly supports cooperative action by the two agencies to adopt the rulemaking necessary to make security index futures in these categories available to U.S. investors. Although SIA does not believe legislation to encourage joint rulemaking to permit U.S. trading in foreign stock and stock index futures and domestic non-equity securities and security indices is necessary, we would support such an initiative if the SEC and CFTC believe they need a legislative mandate. We oppose the security index definition provisions contained in S. 1566.

Retail Foreign Exchange Fraud

General

Critics of the decision of the Seventh Circuit Court of Appeals in CFTC v. Zelener, 373 F.3d 861 (7th Cir. 2004) argue that the decision created or exposed a significant loophole in the CEA that will purportedly provide a road map for retail fraud in a broad range of commodities.

SIA disagrees with this view and believes that the Zelener decision was a correct application of current law and was correctly decided based on the facts in evidence in the case. SIA also does not find credible the claim that the Zelener decision will lead to similar decisions in cases involving retail transactions in physical commodities that typically require costly, complex, and burdensome delivery mechanisms.

Moreover, the absence of CFTC jurisdiction over certain categories of retail commodity fraud does not necessarily result in an enforcement vacuum. Recent actions by the State of California[4] and the Federal Trade Commission[5] are indicative of the availability of other enforcement mechanisms for the protection of retail consumers.[6]

SIA believes that steps to expand CFTC jurisdiction beyond futures should be taken with great care. There are two reasons for this. First, the CFTC has a significant regulatory mission to discharge with respect to the nation's currently regulated futures markets.

These responsibilities already challenge the agency's resources. Steps that might expand the CFTC's role to that of a national police force for consumer fraud involving credit transactions could place significant additional burdens on the CFTC's resources and continued ability to meet the challenges of an extremely innovative and constantly evolving market.

Second, the very uncertainties that gave rise to the need for the CFMA were themselves the result of the potentially expansive scope of the CEA and overlapping jurisdiction of the CFTC with that of the SEC, bank supervisors, and others. Nearly every prior amendment to the CEA involving the scope of CFTC jurisdiction, with the notable exception of the CFMA, has caused significant jurisdictional disputes or uncertainty with adverse collateral consequences. It is imperative that Congress avoids legislative initiatives that will create these problems in new areas of economic activity – particularly where no compelling public policy case has been presented for enacting legislation that might give rise to such risks.

Nonetheless, SIA welcomes the attention of the President's Working Group on Financial Markets to these issues and supports efforts to eliminate or remediate fraud where the need to do so is identified. Consistent with the principles articulated above, however, it is critical that any such initiative be narrowly drawn to address only the substantive antifraud concerns.

In this regard, we oppose the provisions of S. 1566 dealing with these issues and we have serious substantive, policy, and technical concerns with the language, including concerns regarding the scope of transactions that would be covered by the proposed provisions.

Broker-dealer Affiliates

Unrelated to the Zelener decision, S. 1566 would cut back significantly existing provisions of the CFMA that permit SEC-registered broker-dealers and their material associated persons (*i.e.,* their material affiliates), among other entities, to continue to conduct OTC foreign exchange futures activities with counterparties that do not qualify as eligible contract participants.

SIA understands that this proposal responds to a practice in which firms establish and register 'shell' FCMs for the purpose of permitting under-capitalized and unregulated affiliates to engage in retail OTC foreign exchange futures activities. In the context of SEC-registered broker-dealers or their material associated persons, however, no similar problem has arisen, and there is no basis for concluding that any similar problem will arise in the future.

Most U.S. broker-dealer holding company groups have historically conducted their OTC foreign exchange activities in an affiliate of the SEC-registered broker-dealer. These entities are not thinly capitalized and, as noted above, there is no history of any retail foreign exchange related abuse by these entities or by personnel of the affiliated broker-dealer. Requiring reorganization of this business line and registration of personnel could be costly and burdensome and would be entirely unjustified by the record.

As a result, SIA strongly opposes the provisions of S. 1566 that would modify the scope of permissible activities of broker-dealers or their material associated persons under the existing provisions of CEA section 2(c)(2)(B).

Unregistered Solicitors

SIA understands that certain unregulated persons, other than the entities enumerated in existing CEA section 2(c)(2)(B), have commenced operations as solicitors of OTC foreign exchange futures transactions in which FCMs or FCM affiliates act as counterparty. SIA would not oppose legislative amendments that would require such solicitors to be registered with the CFTC where they are not an entity (or an employee of an entity) enumerated in CEA section 2(c)(2)(B) or otherwise regulated.

Legal Certainty Concerns

The CEA is a complex statutory scheme, reflecting, as it does, the richness and complexity of this nation's financial markets. In enacting amendments to the CEA, unintended consequences can readily occur, whether in the form of legal uncertainty, inappropriate restrictions on legitimate activity or competitive disparities.

A potentially significant example of this problem is presented in the context of the Report of the Senate Committee on Agriculture, Nutrition and Forestry accompanying S. 1566. That Report notes:

> The Committee concurs with the CFTC's consistent position that even if a transaction is excluded from the CFTC jurisdiction under Section 2(g), the false reporting of such a transaction is a separate act and remains a violation of Section 9 so the CFTC has authority to prosecute.[7]

SIA agrees that the CFTC has jurisdiction under Section 9 for a false report covered by that section even though, had the transaction falsely described actually occurred as described, it would have been eligible for the exclusion in Section 2(g). A transaction reported falsely by definition did not occur and therefore cannot satisfy the requirements of an exemption applicable to actual transactions. For that reason, the CFTC's enforcement position is justified and we agree with the conclusion reached in the Report.

We do not, however, agree with the basis cited in the Report for its conclusion. The Report suggests that the exclusion provided under Section 2(g) (and, presumably, the other statutory exclusions contained in the CEA) do not, for example, cover false "statements" because they are "separate" from the excluded transactions. The Report thus appears to distinguish between "transactions" that are exempt, on the one hand, and "statements" relating to transactions, which, according to the Report, are "separate" from the transactions and are therefore not exempt. The drawing of a general distinction between exempt or excluded transactions under the CEA and related "statements" or conduct of transactors is not justified under the CEA and could reintroduce significant uncertainty that the CFMA was expressly enacted to eliminate.

Securities-based swaps, for example, are excluded from regulation under the CEA (including the CEA's antifraud provisions) pursuant to Section 2(g). Congress instead explicitly subjected securities-based swaps to antifraud provisions under the securities laws in Title III of the CFMA.

The above-quoted Report language would suggest, however, that statements made in connection with securities-based swaps would be subject to CEA antifraud provisions. This is plainly inconsistent with Congressional intent. Moreover, the logic applied to "statements" could be equally applied to other conduct that is independent of the "transaction", thus giving rise to broader uncertainty as to the extent to which provisions of the CEA regulate statements, communications and other conduct of transactors in connection with the broad range of banking, securities and other financial transactions that Congress assumed it had expressly excluded from regulation under the CEA. Such uncertainty is unacceptable and should be dispelled.

CONCLUSION

The CFMA resolved many significant issues and did so in innovative ways. This has enabled the U.S. derivatives market to provide important benefits for the U.S. economy. As noted above, the complexity of the products subject to the CEA, as well as those covered by exclusions from the CEA, are complex and extremely difficult to define. History has shown that a lack of clarity under the CEA can produce significant adverse consequences. As such, we believe it is extremely important that Congress proceed cautiously to avoid unintended adverse consequences of the type potentially presented by the Report text cited above.

SIA is eager to work with the Committee and its staff to achieve your legislative objectives in a constructive manner that preserves the many benefits of the CFMA.

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[1] The Securities Industry Association brings together the shared interests of approximately 600 securities firms to accomplish common goals. SIA's primary mission is to build and maintain public trust and confidence in the securities markets. SIA members (including investment banks, broker-dealers, and mutual fund companies) are active in all U.S. and foreign markets and in all phases of corporate and public finance. According to the Bureau of Labor Statistics, the U.S. securities industry employs nearly 800,000 individuals, and its personnel manage the accounts of nearly 93-million investors directly and indirectly through corporate, thrift, and pension plans. In 2004, the industry generated $236.7 billion in domestic revenue and an estimated $340 billion in global revenues. (More information about SIA is available at: www.sia.com.)

[2] [63 Fed. Reg. 2805 (Jan, 16, 1998).] Following enactment of the CFMA, in a letter dated March 6, 2001 addressed to the SEC and CFTC, the FRB reiterated its encouragement for the development of "more risk-sensitive portfolio margining approaches for all securities, including security options and security futures products."

[3] Under the current dual regulatory regime, the SEC and CFTC have not adopted the joint rules that would be necessary to permit in options on security futures.

[4] U.S. Commodity Futures Trading Commission and State of California Charge San Francisco Foreign Currency Firm National Investment Consultants, Inc. And Other Companies And Individuals With Fraud, CFTC Press Release July 21, 2005. http://www.cftc.gov/opa/enf05/opa5099-05.htm.

[5] Court Order Bars Deceptive Investment Pitches, Federal Trade Commission Press Release, May 17,2005. http://www.ftc.gov/opa/2005/05/britishcapital.htm.

[6] As noted by former Acting CFTC Chair Sharon Brown-Hruska:

> "I would point out that our overall track record in the forex area is favorable. Since the passage of the CFMA, the Commission, on behalf of more than 20,000 customers, has filed 70 cases and prosecuted 267 companies and individuals for illegal activity in forex. As a result of those efforts, we have thus far imposed over $240 million in penalties and restitution. Of the 70 cases that have been filed thus far, the Commission has lost only three."

Testimony of Sharon Brown-Hruska, Hearings of the Senate Committee on Agriculture, Nutrition and Forestry, March 8, 2005

[7] Report at page 6.