

# LOWENSTEIN SANDLER PC CLIENT ALERT INVESTMENT MANAGEMENT

ATTORNEY ADVERTISING

## SEC AND CFTC ISSUE JOINT REPORT ON HARMONIZATION OF REGULATION

By Scott H. Moss, Esq., Cole Beaubouef, Esq. and Gary J. Cocco, Esq.

October 27, 2009

**On October 16, 2009, the Securities and Exchange Commission (the "SEC") and the Commodity Futures Trading Commission (the "CFTC", together with the SEC, the "Commissions") issued "A Joint Report of the SEC and the CFTC on Harmonization of Regulation" (the "Report"). The Report, which spans ninety-five pages of detailed background and analysis, identifies and evaluates divergent regulatory practices between the Commissions, and recommends actions to address those differences and to "promote the protection of investors, ensure market integrity, and promote price transparency." The Report is a direct response to the Obama Administration's plan for financial industry regulatory reform, which called for the harmonization of futures and securities regulation.<sup>2</sup>**

The Report notes that the existing regulatory schemes of the CFTC and the SEC have caused regulatory uncertainty, particularly when new complex financial instruments are created by market participants.

Ultimately, the Report sets forth twenty recommendations for modifying the Commissions' current regulatory schemes. The twenty recommendations are grouped into four categories addressing: (i) the operation of securities and futures markets; (ii) financial intermediaries; (iii) enforcement; and (iv) operational coordination between the Commissions. Certain recommendations in each of the four categories are summarized below.

### **The Operation of Securities and Futures Markets**

The Report recommends that the Commissions evaluate existing customer protections with respect to current margin requirements, specifically focusing on risk-based portfolio margining. The Report also suggests that the Commissions seek input from the public as to which approach to portfolio margining would be in the public interest.

The Report also expressly addresses concerns about jurisdictional disputes between the Commissions that have often stymied effective regulation. Past jurisdictional disputes often resulted in regulatory uncertainty

relating to new financial product classification, which in turn led to lengthy delays in bringing new products to the market. Recognizing the role of innovation in the securities and futures markets, the Report recommends legislation that would provide for an expedited judicial review of jurisdictional matters. The Report notes that this review would facilitate (i) legal certainty and (ii) an efficient review process to ensure any jurisdictional dispute is resolved against a firm deadline.

The Report further recommends enhancing the CFTC's authority over exchange and clearinghouse compliance with the Commodity Exchange Act (the "CEA"). Currently, the decentralized nature of clearinghouse regulation, while promoting competition, often leads to uncertain regulation of clearinghouses. The Report calls for an amendment of the CEA to provide the CFTC with clear authority to regulate this area.

With respect to cross-border securities transactions, the Report charges the

SEC with reviewing its current approach to enhance the protection of investors and the public interest while achieving greater efficiencies. The Report also recommends that Congress empower the CFTC to require registration of foreign boards of trade.

### Financial Intermediaries

The Report proposes more effective regulation of financial intermediaries. One of the primary recommendations in this area is to create a uniform fiduciary standard for intermediaries who provide similar investment advisory services to futures or securities markets participants. This uniform standard would apply to commodity trading advisors, futures commission merchants, introducing brokers, broker-dealers, or any investment adviser who provides similar investment advisory services.

Other recommendations in this area include aligning the Commissions' current record retention requirements for intermediaries, and providing greater consistency relating to customer risk disclosure documents. Currently, the SEC requires three-year or six-year retention periods, depending on the type of record, and the CFTC requires a five-year retention period. The Report also recommends greater consistency in customer risk disclosure documents, and legislation to expand the CFTC's conflict of interest prevention authority.

Finally, the Report recommends that the Commissions review and, if necessary, align specific private fund reporting requirements that apply to

investment advisers, commodity pool operators, and commodity trading advisors. Specifically, the Report directs the Commissions to remedy inconsistent provisions regarding the use of performance track records, investor reports, and recordkeeping.

### Enforcement

The Report makes a series of recommendations regarding enforcement activities. First, the Report recommends legislation to encourage whistleblowers to come forward with relevant information to authorities, by providing them with more adequate protections from possible retaliation. Second, the Report recommends that Congress more clearly define the scope of customer restitution that the CFTC may recover in civil actions. Third, the Report recommends legislation to enhance the CFTC's authority over disruptive trading practices that undermine market integrity and the price formation process in futures markets, including expanding the scope of insider trading prohibitions under the CEA. Finally, to close the gaps between the regulatory schemes of the Commissions, the Report recommends legislation that would grant the SEC specific statutory authority to bring actions for aiding and abetting violations of the Securities Act of 1933, as amended, and the Investment Company Act of 1940, as amended. The CFTC presently enjoys specific statutory authority to bring actions for aiding and abetting violations of the CEA and CFTC rules and regulations, and the Report believes this change would address this regulatory gap.

### Operational Coordination

The Report also suggests improved operational coordination of the Commissions going forward. Each of the Report's recommendations in this area involves joint action by the Commissions (including joint training programs) or the formation of a joint group to work together in a spirit of cooperation. The recommendations in this area include the creation of a Joint Advisory Committee, Joint Agency Enforcement Task Force and Joint Information Technology Task Force. The Joint Advisory Committee would be tasked with solving emerging and ongoing issues of interest to the futures and securities markets. The Joint Agency Enforcement Task Force would seek to train staff of both agencies and develop uniform enforcement and examination procedures, and the Joint Information Technology Task Force would link publicly available information on regulated persons of both Commissions.

\* \* \* \* \*

As the Report notes, securities and futures have been subject to different regulatory regimes since the 1930s. With different approaches to regulation and the development of new products in the marketplace, securities and futures regulations were, at times, inconsistent. It was also unclear which regulatory regime, if any, governed new products. Jurisdictional disputes between the Commissions created uncertainty in the marketplace and drained resources of both agencies.

LOWENSTEIN SANDLER PC CLIENT ALERT  
INVESTMENT MANAGEMENT

After the market collapse that began in 2008, many market participants, academics, and legislators opined that the Commissions should be combined into a single regulatory body. Commentators argued that this alignment would eliminate inefficiencies that resulted from separate regulatory regimes for securities and futures, and better address modern financial products. Although these initiatives did not gain traction in 2009, the Report represents the Commissions' concerted effort to reform certain aspects of their regulatory practices. Many of the Report's proposals would require not only the Commissions' implementation of revised administrative practices, but also Congressional authorization of the recommendations. The effect of the recommendations set forth in the Reports can vary greatly depending upon exactly how such recommendations are implemented. Financial industry participants, especially those who participate in the securities and futures markets, should stay abreast of SEC and CFTC regulatory developments so that they can guide legislators and regulators seeking public comment and prepare

for changing regulations. Financial industry participants are well advised to contact industry groups now to voice their opinions and concerns about the effect of CFTC/SEC harmonization on their operations or area of expertise, and suggest best practices for implementing the Report's recommendations.

Lowenstein Sandler's Investment Management Group will continue to monitor and report on developments relating to the Report, as well as other legislative, regulatory and industry developments that may be of importance to our clients.

**Please contact any of the attorneys below, or any other member of Lowenstein Sandler's Investment Management Group, for further information on the matters discussed herein.**

**Scott H. Moss**  
973.597.2334  
smoss@lowenstein.com

**Cole Beaubouef**  
973.597.2322  
cbeaubouef@lowenstein.com

**Gary J. Cocco**  
973.597.6188  
gcocco@lowenstein.com

**Robert G. Minion**  
973.597.2424  
rminion@lowenstein.com

**Peter D. Greene**  
646.414.6908  
pgreene@lowenstein.com

**Marie T. DeFalco**  
973.597.6180  
mdefalco@lowenstein.com

**Allen B. Levithan**  
973.597.2406  
alevithan@lowenstein.com

**Elaine M. Hughes**  
973.422.6502  
ehughes@lowenstein.com

**Sherri Venokur**  
212.204.8698  
svenokur@lowenstein.com

**Andres Rueda**  
646.414.6869  
arueda@lowenstein.com

**Richard Bernstein**  
973.422.6714  
rbernstein@lowenstein.com

**Matthew A. Magidson**  
973.422.6762  
mmagidson@lowenstein.com

<sup>1</sup> Available at <http://sec.gov/news/press/2009/cftcjointreport101609.pdf>. See also the related press report, "SEC and CFTC Issue Joint Report on Regulatory Harmonization," dated October 16, 2009, available at <http://sec.gov/news/press/2009/2009-218.htm>.

<sup>2</sup> The Obama Administration's proposal is available at [http://www.financialstability.gov/docs/regs/FinalReport\\_web.pdf](http://www.financialstability.gov/docs/regs/FinalReport_web.pdf).

Lowenstein Sandler makes no representation or warranty, express or implied, as to the completeness or accuracy of the Alert and assumes no responsibility to update the Alert based upon events subsequent to the date of its publication, such as new legislation, regulations and judicial decisions. Readers should consult legal counsel of their own choosing to discuss how these matters may relate to their individual circumstances.

[www.lowenstein.com](http://www.lowenstein.com)

**New York**  
1251 Avenue of the Americas  
New York, NY 10020  
212 262 6700

**Palo Alto**  
590 Forest Avenue  
Palo Alto, CA 94301  
650 433 5800

**Roseland**  
65 Livingston Avenue  
Roseland, NJ 07068  
973 597 2500