February 24, 1983

MEMORANDUM FOR THE TASK GROUP ON THE REGULATION OF FINANCIAL SERVICES

SUBJECT: Coordination of the Functions of the Securities and Exchange Commission and the Commodity Futures Trading Commission

Although often suggested, consolidation of the SEC and the CFTC might arouse strong opposition from their respective constituencies. Therefore, this memorandum explores possible areas of greater coordination of the two agencies which could simplify and reduce regulatory requirements and improve their operating efficiency.

A. Nature of the Problem

The need for improved coordination between the SEC and CFTC stems from the economic similarity of the financial instruments subject to their respective jurisdictions. In general, the regulatory authority of the SEC extends to all non-exempted securities, 1/ and also includes options on all securities, groups and indexes of securities. The SEC also has jurisdiction over securities firms, account executives, investment advisers, and securities self-regulatory organizations such as exchanges.

The CFTC has jurisdiction over all futures contracts on traditional commodities, federal securities and broad-based

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1/ Exempted securities under the federal securities laws include, among others, federal, state and municipal government obligations, bank and savings and loan securities.

indexes, as well as options on such futures contracts. The CFTC also has jurisdiction over commodity firms, their associated persons, and boards of trade.

Many of the foregoing financial instruments, firms and persons regulated by the SEC and CFTC are closely related. In many instances the agencies regulate the same firms and individuals. The existence of two regulatory agencies performing parallel functions results in organizational diseconomies and in duplicative, and sometimes inconsistent, regulation of products, markets and persons.

1. <u>Different Agencies Regulating Directly Competitive Products</u>

The jurisdictions of the SEC and CFTC are divided along product lines so that there is no direct overlap. The term "commodity" as defined by the Commodity Exchange Act encompasses certain instruments that are also "securities" as defined by the securities laws. But where the terms intersect, the SEC has jurisdiction over such instruments and options contracts on them and the CFTC has jurisdiction over futures contracts and options on futures contracts on such instruments.

Although legally distinct, securities options subject to SEC jurisdiction are functionally similar to the futures and options on futures on securities subject to CFTC jurisdiction. For example, options and futures (and options on

futures) on Treasury bonds can be used to hedge the risks of fluctuating interest rates, as well as for leveraged speculation. Other examples of functionally similar instruments include options and futures (and options on futures) on Government National Mortgage Association pass-through securities ("GNMAs"), certificates of deposit, commercial paper and broad-based securities groups and indexes. In addition, the SEC regulates options on foreign currencies traded on exchanges, and the CFTC regulates options on foreign currencies traded on boards of trade. These functionally similar instruments are directly competitive products.

2. Competitive Inequalities

The competitive advantages of certain of these products, firms and markets depend upon their regulatory classifications, rather than their economic merits. For example, because the level of margin represents a cost associated with participation in a market, it is an important competitive factor that may influence market choice. Currently, in the securities market, minimum margin requirements are established by the Federal Reserve Board. Boards of trade set the minimum margin requirements on futures contracts.

In the securities markets, trading on inside information is prohibited. In the futures markets, it is not. This

difference permits transactions in the futures market, prohibited under the securities laws.

Other differences in the regulatory schemes exist with respect to the regulation of professionals conducting a public business and include such matters as disclosure obligations, suitability requirements and supervisory standards. These factors, while unrelated to the economic merits of the various instruments or the quality of the markets in which they trade, may influence a professional's choice of which instrument and market to recommend for his customers.

3. Regulatory Conflict

Many registered broker-dealers, regulated by the SEC, are also registered futures commission merchants ("FCMs"), subject to CFTC regulation. In some cases, associated persons in such firms engage in the sale of both securities and commodities instruments. Subjecting firms and their associated persons to dual regulatory structures increases compliance costs. The SEC and CFTC are making progress in harmonizing their regulatory structures. For example, the SEC and CFTC have, on a number of occasions, coordinated their net capital requirements for broker-dealers and FCMs. The SEC added a segregated funds schedule to its Financial and Operational Combined Uniform Single ("FOCUS") report

which permitted the CFTC to authorize FCM/broker-dealers to substitute FOCUS reports for a portion of their CFTC-required forms. There are other areas in which coordination between the SEC and CFTC could lead to a reduction in regulatory requirements for dual registered firms and professionals. In addition, further coordination of the regulation of commodity pools and investment companies would be beneficial.

4. Possibililty of Intermarket Manipulation

Options and futures (and options on futures) on the same underlying instrument (e.g., Treasury or GNMA bonds) have a predictable price relationship, affording opportunities for intermarket manipulations. Essentially, intermarket manipulation is accomplished by effecting transactions in one market for the purpose of influencing the price of a related instrument in a corresponding market to the benefit of a market participant with a position in that market. Detection of such manipulation requires integration of the surveillance information generated by the related markets.

5. Uncoordinated Enforcement Activities

The conduct of regulated professionals can violate both the securities and the commodities laws when, for example, a customer engages in a strategy that involves both securities and commodities products. In addition,

in the investigation stage, it may be unclear whether fraudulent activity is within the jurisdiction of the SEC, the CFTC, or both agencies. Consequently, at a minimum, close cooperation between the enforcement divisions of the SEC and CFTC is desirable.

B. Proposed Solutions

Economies could be achieved and dual regulations reduced if particular measures to increase coordination are undertaken. These include the following:

1. Formal Establishment of a Joint Policy of Equivalent Regulation

One vehicle by which closer coordination could be achieved would be establishment by the agencies of a joint policy of equivalent regulation. The objective of this policy would be to harmonize regulation of products and professionals in areas where differences in regulation are likely to influence market choice. Because the flexibility of the agencies in harmonizing regulation may be limited by statutory differences, a legislative change which mandates "equivalent regulation" and overrides statutory provisions to the contrary might be useful.

2. Coordination of Margin Requirements Set by Exchanges Under Joint Oversight of the SEC and CFTC

Because margin is an important competitive factor, establishing equivalent margin requirements for competing

options and futures (and options on futures) would help ensure that such products compete on their economic merits.

Minimum margin requirements are intended to prevent firms from setting low margin requirements for competitive purposes. Therefore, the requirement that equivalent margin requirements be set for competing products might be vested in the securities exchanges and the boards of trade, under the joint oversight of the SEC and the CFTC, or a committee composed of representatives of the two agencies, in order to permit quick response to market conditions. Such an oversight mechanism would require legislation.

3. Coordination of Surveillance

Under the securities laws, self-regulatory organizations (the securities exchanges and the National Association of Securities Dealers ("securities SROs")) have primary responsibility, subject to SEC oversight, for conducting market surveillance for the purpose of detecting improper trading activities. Under the commodities laws, both the boards of trade and the CFTC are actively involved in market surveillance. Because effective surveillance of trading in options and futures (and options on futures) on a common underlying instrument requires access to data from related markets, the Commodity Exchange Act was recently amended to permit the CFTC to share such information with

the securities SROs. Correspondingly, the securities SROs intend to make such information available to the CFTC.

Continued cooperation between the SEC and CFTC, with consideration given to improvements in the mechanisms for the exchange of this surveillance data, is essential. In addition, direct information sharing between securities and commodities SROs would be desirable. Such information sharing could take the form of a computerized interface of surveillance data. The creation of a joint body to conduct surveillance activities should also be explored.

4. Formalized Mechanisms For Enforcement Coordination

Several steps could be taken to enhance coordination between the SEC and CFTC in the enforcement area:

First, both agencies maintain computerized files containing information about matters under investigation and the names of individuals and firms involved in prior investigations. While the two agencies are willing to share such information on request, it would be far more effective if they were electronically linked to allow each agency direct access to the computerized files of the other. This step could probably be taken without legislation, although there may be Privacy Act and Right to Financial Privacy Act issues which have to be resolved.

Second, cooperation could be facilitated if the agencies were to exchange enforcement personnel for several months to a year. Such exchanges would familiarize these individuals with the methods, laws and personnel of each agency.

Third, the two agencies could establish a joint team, composed of employees of each, that would investigate and prosecute cases involving both sets of laws. Service on this team could rotate so that a large number of individuals could become acquainted with their counterparts, and the statutes administered by the other agency.

5. Joint Membership in the Two Commissions

A more radical, but more effective, coordination of the two agencies would be to amend the securities and commodities laws to permit the President to appoint the same individuals to each Commission. This would permit coordinated administration of the securities and commodities laws, while preserving the separate statutory schemes. Within that framework, the joint Commissioners could harmonize the regulation of functionally similar products.

6. Locating the SEC and CFTC in the Same Building

Locating the two agencies in the same building would facilitate coordination and permit both agencies to consolidate certain common functions (*i.e.*, utilities, purchasing,

personnel, printing, etc.). Physical proximity of the Commissions and their staffs would also facilitate communication, cooperation and some of the other, more formal, measures suggested above. The SEC recently moved into a new building which may have two or three floors available.