SOME INVESTOR PERSPECTIVES ON FINANCIAL REGULATION PROPOSALS

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Prepared by

Lawrence A. Cunningham

Professor of Law

George Washington University

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Table of Contents

EXECUTIVE SUMMARY

INTRODUCTION

I. CURRENT ENVIRONMENT

- A. *Securities*
- B. *Futures*
- C. *Banking and Insurance*
- D. *Domestic vs. International*

II. MUTUAL RECOGNITION IN SECURITIES REGULATION

- A. *SEC Views*
  1. Actions
  2. Policies
  3. Broker Proposal

- B. *Unaddressed Issues*
  1. Threshold Matters
  2. Limitations

- *C. Summary of Pros and Cons*

III. INTEGRATING SECURITIES AND FUTURES REGULATION

- A. *Procedural Matters*
  1. Merging the SEC and CFTC
  2. Principles Instead of Rules
  3. Expanding the Power of Self-Regulatory Organizations
  4. Fast Track Proposals
  5. President's Working Group

- B. *Substantive Issues*
  1. Margin Accounts
  2. Customer Funds
  3. Insider Trading
  4. Suitability
  5. Short Selling
  6. Private Litigation

- C. *Summary of Pros and Cons*

IV. OPTIMAL REGULATORY STRUCTURE

A. *Short-Term Federal Reserve Powers*

B. *Long-Term Reorganization*

1. Market Stability Regulator
2. Prudential Financial Regulator
3. Business Conduct Regulator
4. Corporate Finance Regulator

C. *Summary of Pros and Cons*

EXECUTIVE SUMMARY

This paper evaluates ideas for overhauling U.S. financial regulation that have emerged amid assertions of the declining competitiveness of the U.S. capital markets and alarm about systemic breakdowns precipitated by the credit crisis. This paper assesses, from an investor's perspective: (1) mutual recognition in securities regulation, (2) integrating securities and futures regulation and (3) a model of financial regulation that relies on a single agency to oversee all financial markets. Much of the analysis focuses on proposals contained in the U.S. Treasury Department's March 2008 *Blueprint for a Modernized Financial Regulatory Structure*.

Mutual recognition in securities regulation refers to agreements that let foreigners participate in one national market without local supervision if they are subject to comparable supervision in their home market. The Securities and Exchange Commission (SEC) and other proponents of mutual recognition believe that it will advance the interests of investors worldwide by increasing access to investment opportunities without diminishing traditional investor protection laws and policies. Some believe that mutual recognition is critical to U.S. capital market competitiveness. Others note that global trends are driving mutual recognition among other nations; the SEC will enjoy a stronger leadership role, they assert, if it pursues mutual recognition actively rather than adopting a wait-and-see posture.

In contrast, opponents of mutual recognition argue that its adoption would diminish cherished U.S. investor protections. Some critics believe that mutual recognition inevitably involves a trade-off of investor protection for investor choice. For example, allowing foreign brokers to sell U.S. securities to American investors without SEC registration could give those brokers competitive advantages over U.S. brokers. Mutual recognition could open the U.S. to the most broker-friendly laws prevailing in other nations and result in the SEC's abdication of some of its domestic authority. The upshot could be a serial ratcheting down of U.S. investor safeguards and an elevation of the interests of brokers, both foreign and domestic. Others believe the SEC is championing mutual recognition *in order* to bolster its global leadership, yet they worry that such a move would be a mistake because it would entail compromises in U.S. investor protections.

Proposals to integrate securities and futures regulation frequently advocate a merger of the SEC and the U.S. Commodity Futures Trading Commission (CFTC). Since financial products increasingly blur the lines between traditional securities and futures instruments, melding the two agencies' philosophies would yield more effective and efficient regulation, proponents say. Some believe that adopting the CFTC's "principles-based" regulatory approach would modernize SEC regulation and facilitate a smoother merger of the two organizations. They also assert that it would enhance investor protection, market integrity, market and product innovation, industry competitiveness and international regulatory dialogue.

In contrast, opponents of integrating securities and futures regulation argue that it could weaken investor protection by incorporating prevailing, weaker futures practices into securities practice. Some believe that fundamental philosophical and regulatory differences between the SEC and the CFTC—on margin accounts, customer funds, insider trading, suitability and private

litigation—warrant a continued distinction between the two entities. Similarly, regarding the rules vs. principles debate, some assert that key distinctions between futures and securities markets justify different regulations. Some opponents of a merged SEC-CFTC conclude that such a step could significantly undermine investor rights and protections.

Finally, there has been much public debate over proposals that envision a major restructuring of the U.S. financial regulatory system under a single agency—generally the Federal Reserve—to oversee all financial markets. Proponents of a single regulator believe that would create an efficient overseer with all the information and flexibility necessary to address future financial crises promptly and effectively. Opponents of a single agency model counter that such a restructuring could substantially diminish traditional investor protections without vigilant, successful engagement by investors in the process.

INTRODUCTION

This paper evaluates ideas for overhauling U.S. financial regulation that have emerged amid assertions of the declining competitiveness of the U.S. capital markets and alarm about systemic breakdowns precipitated by the credit crisis. After sketching current regulatory environments, the paper assesses, from an investor's perspective: (1) mutual recognition in securities regulation, (2) integrating securities and futures regulation and (3) a model of financial regulation that relies on a single agency to oversee all financial markets. Much of the analysis focuses on proposals contained in the U.S. Treasury Department's March 2008 *Blueprint for a Modernized Financial Regulatory Structure*.

A principal investor concern with the blueprint is that it doesn't distinguish investors in securities from other, diverse constituents in various financial markets. The blueprint takes a system-wide regulatory outlook. So it lumps together different industries that it says have converged: banking, insurance, futures and securities. It treats them, collectively, as "the financial market." By taking the viewpoint of a senior regulator, the blueprint may overlook the specific viewpoints of different investors.

This outlook is reflected in some of the language the blueprint uses. For example, it repeatedly refers to "consumer protection" rather than "investor protection." Consumer protection is commonly used to describe laws and policies that safeguard users of banking and insurance products. These users buy related services. The term "customer" is also commonly used in commodities markets. But investors are not primarily consumers or customers. True, they may buy services of brokers or other intermediaries. To that limited extent, they are customers. Yet investors' principal function is suppliers of capital, not consumers. The same outlook is reflected in the way the blueprint characterizes public companies as "sources of securities" and treats securities as "products," rather than viewing companies as issuers of securities and securities as investment contracts.

Another problem with the blueprint's limitations from an investor's perspective is that it addresses securities markets in operational and administrative terms but not substantive terms. While it considers stock exchanges and securities clearing agencies extensively, the blueprint pays scant attention to issuers of securities or their advisors and others who protect investors, such as accountants, lawyers, credit rating agencies and underwriters.

The blueprint blends futures and securities as if there were no or few differences between these contexts. Yet the unnoted differences are considerable. Accordingly, while some proposals may appeal to investors, the blueprint would be improved, and its proposals better evaluated, if the specific class of securities investors were distinguished from those who deposit or borrow bank funds, buy insurance or trade futures.

Investor protection is no part of the blueprint's motivation. The stated motivation is to bolster the competitiveness of the U.S. financial system in the face of competitive pressure from non-U.S. financial markets, some of which have different—and, Treasury believes—better regulatory structures. These differences, plus cross-border capital flows, may disadvantage U.S.

capital markets. The blueprint also notes how complexity in financial markets and investments can disguise risks. Combined, globalization and complexity may render the U.S. regulatory structure sub-optimal. The blueprint outlines an optimal model, along with short- and intermediate-term steps to improve the existing system and prepare to transition to a more beneficial structure.

The blueprint's reference to globalization drives recent SEC engagement with the concept of mutual recognition. The SEC envisions letting foreigners participate in U.S. markets without U.S. supervision if they are subject to comparable supervision at home. For U.S. investors, potential benefits include expanded access to global markets, professionals and investments. But assuring that traditional U.S. investor protections are preserved is a major challenge of mutual recognition. SEC statements and policies on the subject remain vague, although early policy comments and a pending proposal about foreign brokers provide a starting point for analysis. They also invite investor participation in discussions on vital matters such as formulating exactly what comparability means to justify recognizing other nations and how to define what subjects, investments or investors should be included in any mutual recognition program.

Preserving long-cherished investor protections in securities law is vital to consideration by investors of any financial regulatory reforms. The blueprint's shorter-term proposals tend to intensify unitary treatment of all financial markets with the effect of weakening those traditional safeguards. This occurs in proposals to merge the SEC and Commodity Futures Trading Commission (CFTC) and meld their regulatory procedures and standards.

Related procedural proposals would shift to greater use of broad principles instead of detailed rules, increased authority of self-regulatory organizations instead of federal agencies, speeding the approval of certain investment vehicles such as exchange traded funds and using a presidential working group to lead the agencies in formulating principles. Related substantive proposals would adapt regulations from futures to securities that would change laws governing margin accounts, broker protection of investor funds, insider trading, suitability of investments, short-selling and private litigation.

Despite the blueprint's short-term proposals that tend to treat futures and securities as a single market (along with banking and insurance), its longer-term proposals for an optimal regulatory structure appreciate differences between investors and others. They also delineate regulation of direct interest to investors. A danger for investors is that investor protections could be eased in the process of implementation from the short-term to long-term.

The blueprint is extensive in scope, ultimately emphasizing the need to enable a single regulator to be aware of all systemically significant financial matters. To this end, it covers matters that are not of interest to investors and omits matters of great consequence to investors. The following analysis concentrates on proposals relating directly to investors, including mutual recognition and proposals concerning securities and futures. More specific blueprint proposals concerning banking and insurance are outside its direct scope.

I. CURRENT ENVIRONMENT

This section sketches current securities and futures environments and provides brief notes on the banking and insurance environments plus international vs. domestic sources of regulation. The blueprint discusses the four industries separately but strives to portray them as a unified combination of inputs into a general financial market. The following also provides perspective on the contours of securities and futures markets that the blueprint does not mention in order to suggest differences that the blueprint overlooks. It may be a mistake to overlook these differences in the name of unifying the regulatory system.

A. *Securities*

Securities are investment contracts typified by profit-seeking ownership interests in a common enterprise, such as common and preferred stock, or backed by promises to repay borrowed funds, such as corporate debt instruments. They also include options on such contracts. Some 14,000 companies have securities listed on U.S. stock exchanges. The market capitalization of U.S.-listed securities approximates $10 trillion. Total annual trading in securities on U.S. exchanges exceeds $44 trillion; investment advisers manage more than $32 trillion in assets. There are more than 6,000 securities broker-dealers in the U.S., operating through 172,000 branch offices, and more than 1,000 different mutual fund complexes through which Americans invest in securities.

Half of American households, and tens of millions of Americans, own common stock. Many Americans own stock directly, others through index and mutual funds or employer pension and other retirement programs. These investors constitute the central component in the process of permanent capital formation on a large scale in the United States. Millions more Americans participate in securities markets by working for listed companies or their professional advisers.

Securities regulation is dominated by federal statutes and SEC regulations, with a very modest role for states. The principal objective is to protect investors and promote capital formation and well-functioning securities markets. The most important way that regulation does this is by the mandatory disclosures by issuers of public securities. Federal regulations also separately affect supporting actors, such as accountants, advisers, brokers, clearing agencies, directors, credit rating agencies, securities exchanges and securities underwriters. The number of persons subject to SEC oversight is essentially incalculable as it includes all those involved in the elaborate U.S. securities market system.

As a result of the vast scale and importance of securities in American life, the SEC is a relatively large agency. It employs some 3,600 full-time personnel, manages an annual budget of just under $1 billion and operates through four separate divisions and numerous offices. The importance of SEC rulemaking is underscored by the fact that SEC rules are subject to the Administrative Procedure Act. This requires public notice and comment before the rules can become effective. The regime makes extensive use of self-regulatory organizations, mainly securities exchanges as well as professional market makers, specialists and broker-dealers. All of these are subject to SEC oversight; their rulemaking is subject to public notice and comment under federal law.

Both the SEC and investors harmed by securities law violations can bring civil actions for the resulting damages against a wide range of securities market participants, including corporate officials and various securities market gatekeepers.

B. *Futures*

Futures are specialized forms of financial contracts stating an exchange of contractual cash flows according to the fluctuation in value of some reference like a commodity price or market index level. They are created by contracting parties, not issued by an enterprise raising capital. Hundreds of thousands of such contracts, mostly-short term, trade in U.S. futures contracts markets. Contracts are actively traded by several thousand sophisticated financial experts, with some producers and end-users of related products also participating. Futures markets provide pricing, hedging and trading functions that contribute to short-term resource allocation of commodities and financial products. Thousands of Americans are involved in trading futures contracts; unlike the securities market, few ordinary Americans trade futures contracts.

Futures regulation is entirely federal, with no state involvement, through federal statutes and the CFTC. Objectives are mainly to promote orderly trading markets and protect traders and contract parties from fraud or other abuse. In contrast to the SEC and securities markets, there is no need for a regulatory agency to maintain a system of mandatory disclosure by issuers. Traded contracts are not equity or general debt obligations of any issuer and do not represent any ownership interest in any corporate or other legal entity.

On the other hand, many attributes of securities also characterize futures. This leads to classification issues about the instruments and what laws apply. Classification challenge is most acute concerning hybrid instruments such as swaps and over-the-counter derivatives. Congress eliminated many of these challenges as a legal matter by authorizing expanded unregulated markets when only sophisticated traders engage in trading. Still, there is conceptual, substantive and regulatory overlap in some aspects of futures markets so that both futures and securities regulations apply. For example, both CFTC and SEC registration is required of both a commodities contract market trading securities futures and a securities exchange that lists securities futures.

The CFTC focuses on organizing markets where contracts trade. Trading contracts outside of designated markets is illegal in the U.S., with clear rules delineating between contract types. For example, federal futures statutes put outside federal futures laws the trading of designated futures contracts among classes of sophisticated traders. A main rationale for this exclusion is that many futures contracts, especially interest rate swaps and other financial derivative instruments, cannot be manipulated in the way that securities can, and are traded only among sophisticated counterparties. The result is regulation that classifies the market into tiers, proportioning regulatory intensity to market need.

Also unlike securities laws, there is no need in futures regulation to address some groups the SEC addresses—accountants, advisers, brokers, directors, rating agencies and securities

underwriters. These people do not participate in futures contract trading or support its existence. The only similar entities are market intermediaries. They must register with the CFTC and follow its regulations. These address the analogous SEC objectives of trader protection, with disclosure, reporting, recordkeeping and ethical requirements, including rules about handling customer funds and capital maintenance.

The primary parties that the CFTC regulates are clearing agencies and contract market providers. Like the SEC, futures regulation uses self-regulatory organizations, principally the contract markets and professional traders. This limited scope of regulatory intensity leads the CFTC to formulate some regulations in the form of "core principles" rather than delineated rules. Two sets of core principles exist: One set of 18 applies to designated contract markets and a separate set of 14 applies to clearing organizations. These core principles are, in turn, elaborated in detailed rules by the National Futures Association, a self-regulatory organization working under the CFTC's supervision.

In futures regulation, self-regulatory organizations are entitled to self-certify that new rules satisfy applicable laws. This can have the unusual effect of allowing adoption with no or limited public notice or comment. As with the SEC and all other federal administrative agencies, however, the CFTC is subject to the Administrative Procedure Act and other government-in-the-sunshine laws. So rulemaking generally requires public notice and public comment.

The CFTC's relatively modest portfolio is reflected in its scale. Its $111 million annual budget is small compared to that of the SEC and it employs only about 500 full-time personnel. It registers approximately 70,000 professionals in total (including sales people, operators, advisors, brokers, traders and merchants).

C. *Banking and Insurance*

Banking in the United States has traditionally been a dual system, created at both state and federal levels, although both subject to Federal Reserve oversight. Insurance is governed almost exclusively by state law and outside federal supervision or Federal Reserve oversight. In general, neither banking nor insurance is of direct significance to investors. Primary constituents of banks are depositors and borrowers; for insurance, policyholders are the main constituents. Principal legal concerns in both contexts are consumer protection; the principal regulatory concern has been overall financial market stability. Despite these differences, an important theme and aspiration of the blueprint is to unite under a single umbrella, for conceptual and regulatory matters, all four different industries: banking, insurance, futures and securities.

D. *Domestic vs. International*

U.S. financial regulation is made by domestic lawmakers and regulators. At the federal level, this means Congress, the SEC, CFTC and associated self-regulatory organizations. Financial regulation in other countries is also made within each country's legal system. As capital markets and capital flows have transcended national borders in recent decades, many national authorities worldwide have tried to coordinate efforts with each other. Efforts take various forms, with varying degrees of success, given that countries differ considerably from one

another. Nevertheless, there is increasing interest and effort to integrate global financial regulation, including securities regulation.

II. Mutual Recognition in Securities Regulation

Globalization of capital markets has led financial regulators worldwide to explore how to facilitate global capital flows while addressing national objectives. The term "mutual recognition" is often used to describe these efforts, although the term itself is abstract; the content of any mutual recognition program would require examination to determine its effects on investors. In general, the term refers to programs where a domestic regulator, such as the SEC, and its counterparts in other nations, reciprocally cede supervision of non-domestic organizations to their foreign counterparts. This enables foreigners to operate domestically without local registration so long as they are registered under a sufficiently comparable foreign system.

A. *SEC Views*

To date, the SEC has taken small steps towards mutual recognition. These provide clues to future policy orientations. But it has provided no elaboration of a framework and scant details on the general concept. Since mutual recognition is an abstract concept whose details are what matter, the following review is necessarily limited.

1. Actions. The SEC has changed rules so that foreign issuers in U.S. markets can use international financial reporting standards instead of U.S. accounting. It also has proposed rules to ease restrictions on foreign brokers accessing U.S. investors and markets (discussed further below). It pursues uniform international standards for compiling financial data electronically using eXtensible Business Reporting Language, or XBRL. It recently announced a formal agreement with Australia on limited aspects of mutual recognition concerning brokers. That agreement, as well as discussions with the European Union and Canada, contemplates a framework for further development of broad-scale mutual recognition. But the lack of comprehensive or formal proposals on mutual recognition makes it difficult to evaluate the concept except in hypothetical or conceptual terms.

2. Policies. One may begin by noting the SEC's stated objectives in pursuing mutual recognition with selected countries. With European Union countries, for example, goals include increasing transatlantic market efficiency and liquidity, facilitating access of EU and U.S. investors to that transatlantic market, expanding information about foreign investment opportunities to U.S. investors, promoting diversification of securities portfolios, reducing costs and increasing regulatory coordination. To achieve these goals, the SEC envisions the following steps toward establishing a process leading to mutual recognition: (1) an initial agreement with foreign counterparts based on mutual comparability assessments, (2) a formal process to pursue substantive discussions with qualifying countries and (3) a framework to define the scope of discussions and possible agreement.

3. Broker Proposal. The SEC's pending proposal concerning foreign brokers is instructive as to the current SEC's approach to the subject. Designated as Rule 15a-6, it addresses how foreign brokers may work in the U.S. In general, they presently must be

chaperoned by a U.S. broker and are limited to dealing with institutional investors commanding more than $100 million in investments. The proposal eliminates the chaperone requirement, reduces the minimum investment level to $25 million and opens foreign broker access to qualified individual investors.

The SEC's stated rationale for the proposed rule, as well as for adopting its Australian agreement, is that existing restrictions limit the ability of U.S. investors to interact with foreign brokers. However, the SEC's approach may not fully appreciate the extent to which those restrictions are driven by the desire to protect investors. Instead, the SEC acknowledges that, under its approach, U.S. investors would enjoy none of the protections provided by U.S. law, and as a result, requires foreign brokers to disclose these omissions to U.S. investors.

B. *Unaddressed Issues*

The SEC's limited actions on mutual recognition to date and vague objectives and steps suggest how daunting it could be to put the concept of mutual recognition into practice.

1. Threshold Matters. At minimum, any mutual recognition program must address a number of threshold issues at a relatively high level of generality.

- **Some degree of comparability must exist between systems, requiring specification of what comparability means and how it would be assessed.** As extreme examples, comparability can focus on shared general principles (such as an emphasis on investor interests and disclosure supported by active oversight and enforcement by non-bribable authorities) or existence of specific kinds of laws (such as those restricting insider trading or short-selling). Comparability of specific kinds of laws is likely impossible, while comparability of general principles may harm U.S. investors by removing basic U.S. regulatory premises. Finding the optimal balance may be difficult and certainly risks undermining U.S. investor protections.

- **Any notion of comparability requires examining a wide range of systemic features of a nation.** These include the structure and operations of the executive branch (including embassy relations), the legislative branch, securities regulator(s), public prosecutor(s), and the central bank.

- **Most aspects of securities markets and regulation must be evaluated,** including the private sector, investors, issuers, exchanges, broker-dealers, investment advisers, clearing agencies and settlement firms.

- **The difference between the comparability of foreign regulation on the one hand and the domestic regulator's capacity to inspect and enforce those regulations on the other must be evaluated.** For example, suppose that the SEC permits foreign brokers to operate in the U.S. without local registration because they are supervised by an SEC counterpart. How can the SEC know whether particular brokers satisfy requirements? For U.S. brokers, the SEC has power and authority to make direct inquiries and require satisfactory responses. The SEC has no such power or authority concerning foreign

firms, relying instead on assurances or investigative cooperation by its counterpart. It may be difficult to imagine any mutual recognition program that enables the SEC to provide the level of investor protection that is prevalent in the United States. Conversely, it is not obviously burdensome for foreign brokers to register with the SEC if they wish to conduct business in the United States and serve U.S. investors.

- **Any analysis would have to include how a system changes or is likely to change.** This would include, in the case of the United States, the effect of any comparability analysis on various pending reform proposals. Examples are SEC views on international financial reporting, use of technology in financial reporting, and the various regulatory reforms proposed in the Treasury's blueprint discussed in this paper. Challenging, unanswered questions include whether any comparability assessment should be made in light of existing U.S. regulation or that of the envisioned state and how the two relate.

2. Limitations. Challenges facing mutual recognition suggest that it is unlikely, at least in the foreseeable future, for any program to apply to every aspect of securities regulation. After all, securities regulation addresses a wide variety of participants and practices. Examples of participants include issuers and their professional advisers, such as accountants and lawyers; investors; exchanges; investment advisors, brokers and dealers; and clearing and settlement operations. Examples of practices include issuer disclosure, governance requirements established by exchanges and timing and other standards applicable to clearing and settlement organizations. It is unlikely that any mutual recognition program could apply to all of these.

Rather, mutual recognition likely is more suitable for certain highly standardized functions in these various settings. It is more likely feasible to conclude confidently that sufficient comparability exists between certain nations in certain contexts than in others. Similarly, it is likely that mutual recognition would be more defensible, and protective of investor interests, if embraced only for certain kinds of issuers, securities or investors. As examples, a program could be restricted to well-known seasoned issuers but not apply to obscure younger companies, common stocks but not derivatives and sophisticated institutional investors or high net worth individuals but not others. Obviously, each of these delineations poses trade-offs between linking global capital markets and preserving traditional U.S. investor protections.

C. *Summary of Pros and Cons*

- **Proponents of mutual recognition argue that it will advance the interests of investors worldwide by increasing access to investment opportunities without undermining traditional investor protection laws and policies.** Some believe that mutual recognition is important to promote U.S. capital market competitiveness. Others note that global trends drive mutual recognition among other nations, and they suggest that the SEC will enjoy a stronger leadership role if it actively pursues a program rather than adopting a wait-and-see posture.

- **Opponents of mutual recognition argue that mutual recognition risks diminishing traditional U.S. investor protection ideals and traditions.** Some believe that by necessity, mutual recognition involves a trade-off pitting investor protection against

investor choice. For example, allowing foreign brokers to sell U.S. securities to U.S. investors without SEC registration could give them competitive advantages over U.S. brokers. If so, one can expect that an effect of the SEC's foreign solicitude would be the introduction into U.S. law of the most broker-friendly laws prevailing in nations in SEC mutual recognition programs. That could spell abdication to foreign authorities of SEC domestic responsibility, which could result in a serial ratcheting down of traditional U.S. investor protections in favor of the interests of brokers, both foreign and domestic. Others note that while there is little doubt that the SEC is assuming a leadership position in pursuit of mutual recognition, it would likely be a mistake for the SEC to sign mutual recognition agreements solely to enable it to maintain leadership if doing so would compromise U.S. investor safeguards.

III. Integrating Securities and Futures Regulation

As part of the Treasury blueprint's goal to unify financial markets for conceptual and regulatory matters, it proposes to unify all sub-components of the environment. It seeks in the intermediate term to unify futures and securities regulation by merging the SEC and CFTC. This is accompanied by a series of sub-proposals intended to unify substantive regulation of these different environments. This section first considers procedural matters and then substantive issues raised by Treasury's vision.

A. *Procedural Matters*

The blueprint says convergence between securities and futures environments makes separate regulatory regimes for these two areas "untenable, potentially harmful and inefficient." The blueprint's solution is to merge the CFTC and SEC to oversee the futures and securities industries and meld their procedures and practices. A presidential task force explored this idea two decades ago without necessarily endorsing it. But, according to the blueprint, it is now vital to make the change.

1. Merging the SEC and CFTC. One basis for the blueprint's merger recommendation is periodic turf disputes between the two agencies amid struggles to classify financial instruments as either futures or securities. Although the agencies cooperate to resolve disputes, there is no question that it is difficult to classify some products. The line-drawing problem reflects a more important basis for this blueprint recommendation: The two environments share much in common and can be regulated more effectively by a single agency than by two separate ones.

The issue is on what terms a merger of the SEC and CFTC should be made. The blueprint leaves this and many related issues open. It describes the two agencies as having different regulatory philosophies. It suggests that a merger of the two would not entail absorption of one by the other but a melding. The melding would involve taking the best parts of the two separate philosophies and integrating them into an entirely new agency. Yet the blueprint never considers why such philosophical or regulatory differences exist between the SEC and CFTC or whether the justifications for those differences warrant continued distinctions rather than integration. This analytical gap could raise concerns for investors and certainly requires fuller development and evaluation than the blueprint offers.

One possibility—not mentioned in the blueprint—is simply for the SEC to fold the CFTC into an existing SEC division, such as the Division of Markets and Trading—or a new division. This reflects the CFTC's main rationale and function of addressing futures contract markets and clearing operations rather than anything resembling the focus in securities law on issuer disclosure.

2. Principles Instead of Rules. The blueprint references standard rhetoric to assert that the CFTC uses a "principles-based regulatory philosophy" and states that it has characteristic "market benefits" worth preserving in the futures area and expanding into the SEC's securities area. It refers to this migration as a method to "modernize the SEC's regulatory approach." The blueprint never examines what it means by these terms and instead gives isolated, simple examples of contexts in which CFTC has displayed this propensity and how the SEC could follow suit.

As for the CFTC, the blueprint lauds its use of core principles in directing contract markets and clearing agencies on how to operate. It even attaches these core principles as exhibits. The blueprint does not mention nor attach the extensive and detailed rules and regulations that the National Futures Association adopts and requires members to follow.

The blueprint recommends that the SEC mimic the CFTC's core principles applicable to contract markets and clearing agencies and apply them, with suitable adjustments, to securities exchanges and clearing agencies. The blueprint acknowledges that there are important differences between futures and securities markets that justify different regulations. Most importantly, applicable futures regulation principles address contracts "not readily susceptible to market manipulation." Nevertheless, it opines that most "other core principles are compatible with the operations of securities exchanges."

The blueprint does not otherwise evaluate which principles are suitable for adaptation from futures markets to securities exchanges. But it ignores issues and problems that do not exist in the futures context, such as existing deficiencies in aspects of how securities clearing agencies work, especially in the context of counting shareholder votes in director elections and other corporate governance matters. It may be premature to remake securities clearing agencies in the image of futures clearing agencies.

As another example, the blueprint—in reference to securities clearing agencies and exchanges—says: "Embracing such an approach for these sophisticated market participants will not only be more conducive to the modern marketplace, but it will also facilitate a smoother merger of the CFTC and the SEC." The exchanges and clearing agencies may be "sophisticated" but, at least in securities markets, wield power over investors, sophisticated or not, for whom longstanding principles of investor protection exist. It is not obvious that the same principles used for derivative clearing agencies can be used in securities.

The blueprint does not examine the broader environment of securities regulation with which any securities regulator must contend. It never inquires into what it would mean for that field to embrace the so-called "principles-based philosophy" attributed to the CFTC. Nor does it

mention that the CFTC itself, in its direct regulation of intermediaries, does not use the "core principles" it uses for markets and clearers—a context where rules are used heavily. In short, the blueprint's unreflective use of the slogan "principles-based" may be a token pursuit of policies and practices contrary to investor interests.

3. Expanding the Power of Self-Regulatory Organizations. The blueprint encourages greater delegation of regulation to self-regulatory organizations (routinely referred to as SROs). It applauds current rulemaking by SROs in the futures context and urges that the same be intensified for the securities context. This suggestion's purposes are to enable U.S. securities firms to compete with over-the-counter markets and international firms and increase innovation and investor choice. The blueprint says "effective and efficient" use of the SRO rule-change process is critical to the integrity and competitiveness of U.S. markets. The scope would be limited to those rules not "involving corporate listing and market conduct standards." For its part, the SEC has steadily relaxed its oversight of SRO rule changes in the past decade, most recently offering guidance exhibiting a commitment to streamlining the rule-change process considerably.

Several observations and questions from an investor's perspective appear:

- **First, both federal securities laws and federal administrative law generally require agencies like the SEC and CFTC to seek public notice and comment for rulemaking proposals.** These are important components of administrative legitimacy and accountability. They apply equally to delegated rulemaking from agencies to SROs, with limited exceptions for interpretation of existing rules, fees, administrative matters or issues "not significantly affecting investor protection." Attempts to circumvent these procedures in the name of speeding their adoption should be greeted cautiously.

  This can be important to assure channeling of consequential proposals through the formal SEC process rather than through the semi-private SRO process. Although for many rules this may not matter, investors should be aware that decisions concerning whether a rule should be adopted by the SEC or an SRO may be influenced by the extent to which public comment occurs or private adoption is permitted. It also may be possible that the SEC lacks statutory power to adopt a given rule but that SROs face no similar legal constraint. It is possible that the option to channel a provision through the private route could impair investor protection.

- **Second, the blueprint introduces its recommendations by observing that federal futures statutes let *all* exchanges and clearers self-certify so that their rules are final without agency approval, including for new instruments.** The blueprint states: "Many futures market participants claim that this self-certification provision has substantially contributed to the growth in the futures markets." This growth is implicitly assumed to be an obvious positive factor. However, it is not obvious that such growth, or at least such rapid growth, is an unqualified good.

  Even if rapid growth is an unqualified good in futures markets, it is not obvious that growth in securities offerings is an unqualified good. Nevertheless, the blueprint

supports its recommendations by reporting complaints about SEC delays, especially as to trading systems and new ways to package and offer securities to investors. The blueprint emphasizes the value of investor choice that is otherwise foregone by delay, without noting issues of investor protection. In addition to ignoring investor protection and dwelling on curbs on investor choice, the blueprint emphasizes its concern for the competitiveness of U.S. financial firms. The SEC's own recent guidance on the SRO rule-change process is more cautious and reflects awareness of the criticism.

- **Third, the exact limitation on the scope of self-certification requires study.** The blueprint says: "By limiting self-certified SRO rule changes to non-retail investor-related rules, investor protection will be preserved." The blueprint does not elaborate on what level of investor protection is preserved, how it would be preserved, whether it is now at the optimal level or should be enhanced, or how self-certified SRO rules in other contexts would impair investor protection. In addition, the phrase "non-retail investor related rules" is unclear and at least suggests a different meaning than another phrase, used elsewhere, that would allow self-certification other than for matters "involving corporate listing and market conduct standards." Investors should watch this closely, and weigh in on any SEC or Congressional pursuit of this Treasury recommendation.

- **Fourth, the blueprint says that "market participants will be reluctant to self-certify rules harmful to the marketplace."** The reference to "participants" in this context is to brokers, dealers and exchanges. It is not to investors. The reference to "marketplace" likewise does not seem to include these most vital actors in securities investment. The assertion that the former would only reluctantly take steps to harm the latter is difficult to square with historical experience or regulatory requirements. The discussion reflects the viewpoint of an optimistic senior regulator distanced from securities markets and from traditional notions of investor protection.

4. Fast Track Proposals. The blueprint supports its proposal to increase the power of self-regulatory organizations in the name of speeding up the regulatory process. In addition to generally urging the SEC to hasten approval of new ways to invest in securities, it makes two specific suggestions.

The first concerns exchange traded funds. The current approach to these instruments is for individual applications to be made to the SEC. According to the blueprint, since 1992, the SEC has issued 50 exemption orders that have authorized some 300 exchange-traded vehicles. The blueprint quotes a former SEC official urging exempting these and other "products currently trading successfully in other jurisdictions" and that doing so is possible "consistent with investor protection." The specific proposal would allow the sale of new variations of exchange traded funds already approved without requiring registration as an investment company.

The justification for these proposals is familiar: to "allow U.S. securities firms to remain competitive with the over-the-counter markets and international institutions and increase product innovation and investor choice." Otherwise, this leads promoters to use non-U.S. markets, reducing industry competition, growth and profits; it also "limits investor choice."

The notion of such approval being "consistent with investor protection" is the blueprint's spirit. It seeks consistency with this notion as if it were a constraint or annoyance that gets in the way of progress rather than the central element in capital formation that securities regulation supports. On the specific suggestions, this may be unobjectionable. Investors nevertheless should be alert to this orientation when considering this and other blueprint proposals.

The second concerns a new form of investment company. The blueprint cites a 1992 SEC Report (*Protecting Investors: A Half Century of Investment Company Regulation*) that suggested creating a new "unified fee investment company" to overcome comparative U.S. tax disadvantages of investments in funds (*e.g*., federal tax law imposes distribution and withholding on income and gain on shareholder investments whereas foreign investment companies are not so burdened until redemption). The blueprint cites such tax and other impediments to this form of company and urges that the effects are both to limit investor choice and limit the growth and prosperity of the fund industry.

The blueprint proposes to overcome these perceived problems by urging the SEC, in consultation with investors and others, to propose legislation to amend the Investment Company Act to authorize registration of a new global investment company. It would presumably be freed of the existing limitations, in tax law and otherwise, although the blueprint does not provide any details. It does emphasize that any such legislation "should provide investor protections equivalent to the current U.S. investment company regulatory framework, such as a robust governance system, fee disclosures, and other disclosures."

5. <u>President's Working Group</u>. The blueprint suggests that merging the SEC and CFTC requires identifying and then melding their philosophies. To do this, it first proposes that the SEC adopt core principles for exchanges and clearers and then increase SRO delegation, as discussed above. It then suggests that the two agencies work in a task force to agree on further matters, Congress pass legislation directing a melding of the philosophies, and the President's Working Group (PWG) define for the merged agency general principles addressing investor protection, market integrity and financial system risk reduction.

Investors and others should be cautious about the PWG setting such principles. The PWG, established in the mid-1980s by presidential executive order, is the least accountable of all potential institutions that could be given such power. It is not obviously inappropriate for the PWG to exercise this authority. After all, PWG has long provided input into financial and market matters under the Treasury Secretary's chairmanship and co-led by the Federal Reserve and heads of the SEC and CFTC.

Yet the blueprint proposes expanding these powers by executive order and broadening the PWG's role. Investor interests could be jeopardized. First, it is not obvious how lodging this power in the PWG would affect the process of public notice and comment. Second, executive orders are not subject to judicial review and extensive consolidation of executive power can result. Third, although the blueprint's direct discussion of proposed PWG powers (pp. 6, 44, 76) presents them in discrete terms, the blueprint also imagines the PWG playing bolder roles, especially establishing the principles that would guide a merged futures-securities agency.

In short, all procedural matters addressing integrating securities and futures regulation are motivated not by concern for investor protection but by global, competitive and industry imperatives. References to investor interests center on expanded investor choice. References to investor protection are used to defend proposals as "consistent with investor protection." This subordination of investor protection to investor choice should make investors cautious about how these proposals develop.

B. *Substantive Issues*

The blueprint proposes that legislation merging SEC-CFTC include "a process to merge regulatory philosophies," discussed previously, and also specify how to "harmonize futures and securities statutes and regulation." These steps, the blueprint says, will "enhance investor protection, market integrity, market and product innovation, industry competitiveness and international regulatory dialogue." It does not specify how any of these steps would enhance investor protection.

In addition to the blueprint's reticence concerning what those philosophies are and its limited assessment of how the markets and participants differ, the blueprint does not state substantive preferences for unification on the topics it identifies as divergent. Instead, it gives a list of descriptive paragraphs of some of the many differences and suggests that Congress, the agencies and the President's Working Group work to eliminate them. The following takes the suggestions in turn, in each case supplying perspective on the differences that the blueprint does not.

1. Margin Accounts. The blueprint acknowledges that the concept of margin is a "very different concept in the futures and securities worlds." Margin in securities practice means a minimum equity stake to buy securities on credit; in futures practice, it is the equivalent of a security deposit made when taking a futures position. The different meanings reflect different environments. The blueprint notes that, for some contexts, namely addressing the concept of margin in relation to a portfolio of securities, the SEC and CFTC have agreed on some methods but not a single approach. It is not obvious that such an agreement is necessary in general or as a precondition to merging the operations of the two agencies.

2. Customer Funds. Securities laws protect investor funds that investors held in brokerage accounts with broker-dealers. First, the latter must maintain customer funds in segregated accounts. Limited authorization is provided for broker-dealers to net from those accounts amounts customers owe for services rendered. Second, investors in securities are protected from broker-dealer insolvency that would otherwise put their brokerage account funds at risk though the Securities Investor Protection Corporation.

There is no parallel insurance for traders in futures; futures laws require some futures merchants to segregate customer funds from their own but allow commingling of all customer funds. Neither group of fund-holders may use customer funds for their own purposes, although futures merchants can lend customers' margin funds to other customers and the law provides a mechanism for some traders to waive these protections. Treasury does not opine on which of

these approaches it favors or explore why the differing markets or participants may justify the comparatively lax futures laws compared to the comparatively protective securities laws.

3. Insider Trading. For generations, insider trading in securities has been illegal in the U.S., both under fiduciary principles in state corporate law and in principles against misappropriation under federal law. Most of this law is decisional law, developed by courts, applying anti-fraud concepts. Although the vast weight of opinion favors treating insider trading as illegal, a vocal minority of critics challenge the economic and legal bases of prevailing doctrine. Nevertheless, prohibitions against insider trading in securities generally resonate with American investors and political sensibilities. In contrast, the scope and level of legal prohibitions and risks of insider trading in futures are narrower. A wide swath of the futures markets involves contracts that are simply not susceptible to insider trading.

The blueprint provides the following single sentence on the subject in discussing contexts in which futures and securities regulation might be harmonized: "While both the securities laws and the [Commodities Exchange Act] contain provisions prohibiting insider trading, the prohibitions under the securities laws, and the penalties applied, are generally considered to be much more stringent and extensive." The blueprint thus does not opine on whether insider trading law should be made more stringent in the futures context or less stringent in the securities context. But inclusion of this point signals interest in debate, discussion and possible changes in one or the other. Investors who oppose insider trading in the securities of publicly traded companies should be cautious about how this discussion proceeds.

4. Suitability. U.S. law has long required that brokers evaluate the suitability of investments for customers before recommending them, requirements sustained in current federal law and SEC regulation. U.S. law imposes no such explicit requirements on futures intermediaries, although the self-regulatory organization for the industry, the National Futures Association, sets suitability rules for its members, pursuant to other provisions of federal law. Securities investors benefit from the investor protection content of suitability rules. It is not clear that the same laws must govern in both futures and securities.

5. Short Selling. Short selling of securities is a wager on a price decline and can, in some circumstances, amount to market manipulation. Accordingly, federal securities laws limit this practice (and the SEC further restricted it for some securities as a credit crisis widened in mid-2008). In contrast, futures markets involve such speculative gambles as a matter of course and, accordingly, no such regulations exist. Once again, the blueprint suggests that there is something anomalous about this differentiation without either considering the differences between these markets or how investor protection is maintained by limitations on short selling in securities markets.

6. Private Litigation. Investors in securities who have been defrauded are generally entitled to sue primary actors. As with insider trading laws, these rights of action have been developed principally by judicial decisions, implying such private rights of action from the broad anti-fraud principles of federal securities statutes. The blueprint states that such investor rights to sue "may generally be more available under the securities laws than under [futures laws]." Again without expressly opining on which approach should be taken for harmonization and

without exploring why these differences exist or what purposes they serve, the implication is a stance opposing such private rights of action.

As with insider trading laws, there is debate within academic finance and law concerning the appropriateness of implied private rights of action and their effect on the securities-law goals of deterring fraud or compensating defrauded investors. The blueprint's somewhat casual reference to this issue should not hide the fact that listing the issue on the harmonization agenda invites new public discussion and debate. It does so using a context that may obscure or bias the perceived merits of the issue. It may be misleading to compare securities markets to futures markets, where fraud is simply a less possible, common or likely phenomenon.

C. *Summary of Pros and Cons*

- **Proponents of integrating securities and futures regulation argue that, because financial products increasingly blur the lines between traditional securities and futures instruments, merging the SEC and the CFTC and melding their philosophies would result in more effective and efficient regulation**. Some believe moving the SEC to the CFTC's "principles-based regulatory philosophy" would modernize the SEC's regulatory approach and facilitate a smoother merger of the two organizations. Those steps may enhance investor protection, market integrity, market and product innovation, industry competitiveness and international regulatory dialogue.

- **Opponents of integrating securities and futures regulation argue that such integration could weaken important investor protections by incorporating prevailing, weaker futures practices into securities practice**. Some believe philosophical and regulatory differences between the SEC and the CFTC and the reasons for the differences—including differences in margin accounts, customer funds, insider trading, suitability, insider trading and private litigation—warrant a continued distinction between the two entities. Similarly, regarding the rules vs. principles debate, some note that important differences between futures and securities markets justify different regulations. Ultimately, a SEC-CFTC merger, depending on its structure, could significantly and negatively impact investor rights and protections.

IV. OPTIMAL REGULATORY STRUCTURE

The blueprint offers sweeping views of the future in what it declares to be "the optimal structure" of U.S. financial regulation. Short-term, it proposes formally legitimizing the lending to non-depository institutions undertaken by the Federal Reserve Board during the credit crisis that began in 2007. Long-term, it proposes broadening the Fed's power, and creating two adjunct authorities, one to regulate financial aspects of institutions enjoying explicit government guarantees and one to regulate the business conduct of those and other financial institutions. In addition, the blueprint presents with limited elaboration a corporate finance regulator, which would resemble the current SEC (after merging with the CFTC). Its functions, which could appear more modest than at present, could be absorbed into the business conduct regulator. Of the proposals, the most significant to investors are those addressing the business conduct

regulator and corporate finance regulator. They are discussed at the end of this section, which first presents the overall proposed regulatory structure, to provide context.

A. *Short-Term Federal Reserve Powers*

The blueprint's most significant short-term suggestion for general regulatory authority over financial matters is the formal expansion of powers the Federal Reserve Board exercised to address the credit crisis that began in 2007. That is when the Fed, for the first time since the Great Depression, made loans to non-depository institutions through its discount window, the lending facility of last resort in the United States. According to the blueprint, taking this step reflected the "fundamentally different nature of the market stability function in today's financial markets compared to those of the past." To others, it amounted to a federal bailout of investment banking and other securities firms.

Whichever view is correct, there is no doubt that this exercise of authority was radical and carried enormous systemic implications. The blueprint suggests conducting an official government study of these implications. The blueprint opines, however, that the Fed's actions properly balanced promoting market stability with risks associated with extending federal support to investment banks (chiefly the risk that this will encourage imprudence, a risk called moral hazard). It suggests allowing the Federal Reserve to take these steps on a more regular basis, recognizing that doing so should be rare and subject to conditions, such as supermajority board approval.

Even so, the blueprint acknowledges that, at present, neither the Treasury nor the Federal Reserve has the necessary information to make precise prescriptions reliably. Accordingly, the blueprint is an initial step in a discussion about the importance of consolidating overall market-wide information in a single regulator. The blueprint's viewpoint is firmly that of a senior regulator anchored in a unitary conception of all participants in financial markets. Notably, a presidential task force made a similar recommendation in a report evaluating the stock market break of October 1987.

B. *Long-Term Reorganization*

The blueprint presents a model for an optimal regulatory structure intended to depart radically from the prevailing one. In it, the blueprint both recognizes different enterprise business models and different government interaction with enterprises. Thus, it distinguishes consumer/retail transactions from business/wholesale transactions and distinguishes firms with government guarantees from those without them. Nevertheless, it aspires to outline a "modern" regulatory structure to reflect "convergence of the financial services industry."

The blueprint sets three regulatory objectives and envisions three regulators to achieve them: overall market stability by the Federal Reserve, financial supervision of firms with government guarantees by a prudential financial regulator akin to prevailing approaches and protective regulation for all financial firms by a new business conduct regulator. These are supplemented by federal agencies charged with (a) administering the system of explicit

government guarantees and (b) supervising public securities markets, presumably including futures markets, to encompass corporate disclosure, governance, accounting and auditing.

The blueprint arrives at this model by eliminating alternatives: (1) *institutionally-based functional regulation* describes the current system, the chief weakness of which is that no single regulator has all information or coordination power; (2) *pure functional regulation* based on activities, the chief weakness of which is trouble delineating activities that often overlap and multiple regulators of individual firms; and (3) a *single consolidated regulator* for financial and consumer protection regulation, the chief drawback of which is it can limit synergies and reduce market innovation. The proposed model overcomes these weaknesses and its chief drawback, assuring communications between regulators, can be met, the blueprint says.

The blueprint expressly acknowledges that there are numerous issues and that it does not address all of them but only begins to identify main ones. Despite this reticence, the blueprint is clear in offering a summary of guidelines that would govern regulation throughout all these agencies. First, agencies would coordinate closely, perhaps with a coordinating body led by the Treasury Secretary. Second, funding would be generated by fees imposed on regulated firms. Third, all regulation would be governed by stated general principles: "guidelines for regulatory process (e.g., public comment), analysis (e.g., cost-benefit analysis and alternative analysis), and review (e.g., monitoring compliance with the principles and reports to Congress)."

1. Market Stability Regulator. The blueprint envisions the Federal Reserve continuing as at present except with broader jurisdiction. It would continue as the central bank, setting monetary policy and serving as lender of last resort, among other traditional macroeconomic functions. Its supervision would extend to all financial institutions, not just depository institutions. This expansion is said to reflect changes in financial markets, in which non-depository institutions play at least as vital a role as depository institutions once did. In this vision, the blueprint emphasizes repeatedly that authority would be "broad, important and difficult to undertake."

The blueprint notes that the market stability regulator would require extensive information from all related regulators and all financial firms. The Federal Reserve's intervention powers would be "limited to instances threatening overall financial stability." Ideally, the existence of this power would influence market behavior and make its exercise unnecessary. The blueprint suggests, by example, that if the Fed had information about various instruments ahead of the pending credit crisis, it could have published it and firms would have responded by reducing their exposure.

The blueprint envisions two aspects of the Fed's traditional lender of last resort function. One would be regular discount window operations, along traditional lines. A new one would be called a "market stability discount window." This would be available on more flexible terms, as to types of loans and borrowers. The flexibility could be more effective to address short-term liquidity needs than the traditional discount window alone, the blueprint says.

The issue is risk of actual or perceived bailouts. One purpose of the blueprint's optimal structure is to reduce this likelihood. The Fed's expanded scope of supervision, information and

lending powers would focus on overall market stability by cutting across all financial institutions and thus reduce the systemic significance of any given firm. Safeguards against excessive support would be needed, including supermajority voting.

2. Prudential Financial Regulator. The blueprint says prudential financial regulation refers to things like capital adequacy, activity limits and related supervision. It is akin to regulation now applicable to depository institutions. In the blueprint, this regulation is necessary to address moral hazard that arises from explicit government guarantees. The blueprint imagines a new federal charter for all financial institutions enjoying explicit government guarantees. It says the traditional U.S. model of federal plus state banking regulation and experimentation is no longer useful. So it recommends a new federal charter for all depository institutions to replace the fragmentary chartering system. It draws the same conclusions for insurers, suggesting all become federally chartered. All such guarantees, including for insurers, would be administered by a reconstituted Federal Deposit Insurance Corporation (FDIC). The prudential financial regulator would oversee all such chartered firms.

3. Business Conduct Regulator. Of potentially great significance to investors is the blueprint's call to create a business conduct regulator. It would have authority over all types of financial firms, not only those overseen by the prudential financial regulator, but also broker-dealers, hedge funds, private equity funds, venture capital funds, mutual funds, securities and futures firms and others. All would be subject to identical national standards overseen by this single agency. This regulator also would eventually oversee all financial markets, including securities and futures markets.

This regulator's primary function would address interactions between financial institutions and consumers (the blueprint uses the word "consumers" in this context when it means to include investors too). The overriding purpose is consumer (again, read investor) protection. The scope includes all financial products (again the use of this term reflects the blueprint's emphasis on consumers when, in this context, it also means corporate equity and debt through which investors supply capital, not buy "products"). The blueprint focuses on financial services in securities markets, not on investor needs concerning such matters as accounting, auditing or issuer disclosure. Treasury must explain how such matters would be affected.

For firms that the business conduct regulator supervises, services and "products" (including securities) regulatory focus would be on information, disclosures and business practice standards. It would include prohibitions against unfairness, deception and discrimination. It would also include regulation of financial capacity and expertise. It would not include power to prohibit products, limit entry, control prices, impose rigid licensing or "provide full protection to consumers (such as with explicit government guarantees)."

Despite the blueprint's basic conception of convergence across financial contexts and the senior regulator's outlook, discussion ultimately recognizes important differences between kinds of institutions, participants and services or "products" (including securities). For example, the blueprint notes that "the requirements for financial capacity and managerial expertise should vary by type of financial product being sold." So many variations appear that it becomes

difficult to accept the blueprint's opinion that there is a single financial market suitable for singular regulatory oversight.

The blueprint adds that the business conduct regulator's "minimum requirements should also be flexible enough to accommodate requirements resulting from membership in various exchanges or clearing organizations." It expands this point to encourage greater use of self-regulatory organizations (SROs). It acknowledges that the regulator could approach its mission by adapting the prevailing approach to banking or insurance; but it strongly encourages instead invoking the securities and futures approach which "relies on SROs for many aspects of regulatory implementation and oversight."

The upshot of this model is to consolidate in one regulatory structure the prevailing regulatory variation among securities, futures, banking, and insurance firms. It does so with a single set of national standards for all "retail financial transactions" providing "consumers with a consistent set of information and protections." It then imagines delegating as much of the resulting authority as possible to SROs.

Achieving this vision requires extensive renovation of the existing system. For banking, including truth-in-lending and anti-deception laws, this means rolling up all existing state and federal law into this single regulator. For insurance, including policy terms and fair practice laws, it requires shifting from states to this federal level, along with the elimination of rate regulation. For securities and futures, the blueprint acknowledges greater difficulties for any such integration, leading to the need for another new federal authority called the corporate finance regulator.

4. <u>Corporate Finance Regulator</u>. The proposed corporate finance regulator is of potentially greatest significance to investors. It would resemble today's SEC and "remain responsible for general issues related to corporate oversight in public securities markets." But the *business conduct regulator*, *not the corporate finance regulator*, would be responsible "for the regulation and oversight of financial institutions and the futures and securities markets." At present, therefore, the SEC and CFTC would merge and the SEC's current portfolio would gradually reduce to focus solely on investor protection associated with the mandatory disclosure system rather than with exchanges, clearing agencies, and securities firms (or contract markets and futures firms).

The business conduct regulator's licensing of securities and futures firms could follow current law that distinguishes between these fields and related laws. The blueprint prefers collapsing this practice based on its concurrent proposal to integrate futures and securities regulation as discussed above. Further, while the blueprint does not dwell on details; it mentions that this regulator's duties, for securities and futures firms, include establishing best execution and investor suitability standards. Here the blueprint again must distinguish these firms from banks and insurers. For example, some federally chartered financial firms will hold or manage client assets, so traditional fund segregation laws must apply.

But having undertaken the process of merging the CFTC and SEC, increasing use of vague principles over detailed rules, and expanding delegation from federal agencies to self-

regulatory organizations, the content of these investor protection laws are likely to differ radically from present law or laws that emerge in the usual manner. Indeed, at this point, the blueprint recommends that if the Securities Investor Protection Corporation is retained, it should be "recast as part of an SRO structure." An SRO structure would likely produce laws and regulations that differ from those generated by Congress or the SEC.

C. *Summary of Pros and Cons*

- **Proponents of a model of financial regulation featuring a single agency overseeing all financial markets argue that such a structure creates an efficient model that ensures that a single responsible regulator has all the information and flexibility necessary to address future financial crises promptly and effectively.**

- **Opponents of a model of financial regulation featuring a single agency overseeing all financial markets observe that such a structure could, absent vigilant and successful investor engagement, substantially diminish investor protections.**