New Legislation Permitting Stock Futures: The Long and Winding Road

William J. Brodsky
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Congress enacted the Commodity Futures Modernization Act of 2000 ("CFMA") in December 2000 in an effort to provide legal certainty to the over-the-counter derivatives markets and regulatory relief to the registered futures exchanges. In doing so, the CFMA trekked into the murky and often choppy waters of the boundaries of commodities, securities, and banking laws and their application to various forms of derivative products. One of the maelstroms raised in the legislative process was how to treat futures on individual stocks and narrow-based indexes (referred to as "stock futures" for this article).

Stock futures had been prohibited since 1982 precisely because a former Congress had been unable to settle how the securities and commodities laws would apply to a product that was essentially a leveraged version of stock. The CFMA addressed this conundrum by permitting stock futures, but regulating them as both securities and futures subject to joint regulation by the Securities and Exchange Commission ("SEC") and the Commodity Futures Trading Commission ("CFTC"). While this approach minimized the regulatory disparities that would have occurred if a security-like product such as stock futures were regulated only as a commodity, it highlighted the regulatory anomaly underlying the entire structure of securities regulation in the U.S. Specifically, the division of the equity and equity derivatives markets into legal categories of securities and futures, each with different laws and different regulators, is an antiquated, inadequate, and burdensome means of overseeing these markets as they face challenges from new technological and international competitors. The U.S. is the only major securities market with such a bifurcated system.

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1 The bill was signed into law December 21, 2000.
This article will explain how the stock futures issue arose, how Congress handled it last year, and the application of the legislation to this new product. While I believe that the approach taken in the CFMA will allow stock futures to trade on a level regulatory playing field in many areas with stock options, which are regulated solely as securities, it will not remove all the disparities between these two competing products. That will only occur when Congress acquires the political will to merge the SEC and the CFTC to create a modern regulatory system for the U.S. equity markets.

I. HISTORICAL BACKGROUND OF THE CFMA

The history of the CFMA is actually more than 26 years old, dating to the creation of the CFTC in 1974. At that time, Congress created the CFTC as a separate agency to regulate the commodities markets, including futures on commodities. Problems soon arose over jurisdictional boundaries of the new agency because of the vague reach of the term "future" and the expansive definition of the term "commodity" under the Commodity Futures Trading Commission Act of 1974 that amended the Commodity Exchange Act ("CEA"). The problems led to turf battles between the SEC and the CFTC when new derivative products arose and both agencies claimed regulatory title. The situation eventually led to litigation over options on GNMA securities, when the SEC approved the Chicago Board Options Exchange's ("CBOE") proposal to trade the product under the securities laws. The CFTC and the futures exchanges sued, claiming that the product was a commodity option subject to the commodity laws. The Seventh Circuit Court of Appeals sided with the commodity interests because of the vague and sweeping breadth of the term "commodity" appeared to capture various types of financial instruments other than stock.

To forestall further litigation over other new derivative products, the SEC and CFTC entered into a jurisdictional accord ("Accord") in 1981 known as the Shad-Johnson Accord (named after the chairmen of the two agencies at the time), which was enacted into legislation in 1982. The Accord divided jurisdiction over derivative products between the two agencies, largely along the line of the products under their respective jurisdictions at the time. The SEC retained jurisdiction over options on securities and securities indexes, while the CFTC retained jurisdiction over

\[\text{References:}\]
\[\text{Commodities Futures Modernization Act of 2000, Pub. L. No. 106-554, Sec. 1(a)(5), 114 Stat. 2763 (2000) [hereinafter CFMA]. These amendments expanded the definition of commodity to cover "all other goods and articles, except onions" as well as "all services, rights, and interests in which contracts for future delivery are presently or in the future dealt in."}\]
\[\text{CBOT v. SEC, 677 F.2d 1137 (7th Cir. 1982) vacated as moot by, 459 U.S. 1026 (1982).}\]
options on commodities (other than those involving securities or indexes of securities) and on all futures, including those on securities indexes.

The CFTC’s jurisdiction over securities futures, however, was limited to futures on broad-based indexes of securities. During negotiation of the Accord, the two agencies were unable to reach agreement on the treatment of futures on individual stocks. The SEC expressed serious concerns that if stock futures were regulated as futures and not as securities, the lack of securities market protections could cause stock futures to disrupt the market for the underlying stocks, impair market integrity, and lead to regulatory arbitrage. Unlike securities, including stock options, futures were not subject to insider trading prohibitions, suitability requirements for recommendations to customers, and federal margin regulation. Despite these concerns, the CFTC insisted that stock futures be regulated under the CEA, while the SEC believed they should be regulated as securities. As a consequence of the disagreement, the two agencies determined to ban futures on individual stocks. They also agreed to prohibit futures on narrow-based indexes of stocks, which easily could be used as a surrogate for a future on an individual stock.5 The two agencies also agreed to do a study on the issue, but they never conducted the study. As I will discuss later in this article, had the agencies conducted such a study, they would have been able to analyze the issues arising from stock futures in a more measured manner rather than in the forced, hurried manner of the CFMA legislative process last year.

The inadequacy of the Accord was soon exposed. The stock market crash in October 1987 highlighted the illogic of separating jurisdiction over securities and security-based derivatives between two different agencies with completely different legislative mandates and philosophies. A presidential task force study of the crash emphasized that the markets for securities and derivatives had become inextricably linked and the Department of Treasury soon introduced legislation to consolidate jurisdiction of all security-based futures in the SEC.6 Strong lobbying efforts by the futures industry easily derailed the legislation, largely because oversight of the SEC and the CFTC was split between different committees in the House and Senate and the agricultural committees with authority over the futures industry did not want to relinquish any jurisdiction.

For the next decade, little attention was given to amending the Accord and scant interest was shown in reopening the prohibition on stock futures. Part of the lack of interest in stock futures emanated from the dismal experience of stock futures abroad. The handful of foreign markets trading stock futures garnered little volume and posed no competitive threat to U.S. markets. During the huge growth in stock trading volume and the run-up in

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the stock market in the late 1990s, the futures exchanges decided that they
wanted to extend their market share from broad-based futures indexes into
sector based indexes, and sued the SEC to gain this ability.\footnote{Board of Trade of City of Chicago v. Securities and Exchange Commission, 187 F.3d 713 (7th Cir. 1999).}

Despite the general lack of attention to the Accord, however, marketplace changes over the decade further dramatized the antiquated nature of
the Accord. New financial products were introduced that crossed the
boundaries between securities, commodities, and banking products. These
so-called “hybrid products” raised legal uncertainty as to their status under
the Accord. The development of the swaps and over-the-counter (“OTC”) derivative markets also raised legal uncertainty issues. Swaps and OTC de-
rivatives are privately negotiated derivative contracts between institutional
counterparties. These products grew exponentially in volume and sophisti-
cation during the 1980s and 1990s and became an important part of financial markets. Yet, legal uncertainty existed as to whether these products came within the ambit of the CEA. If they did, they would run afoul of the
CEA’s prohibition on off-exchange trading of futures unless exempted by
the CFTC. A concept release issued by the CFTC in 1998 that suggested
that many OTC derivative products might be deemed futures created further
legal uncertainty concerns over these products.\footnote{Commodities Futures Trading Commission Proposed Rules, 63 Fed. Reg. 26114 (May 12, 1998) (to be codified at 17 C.F.R §§ 34-35).}

After issuance of the CFTC’s Concept Release, OTC derivative dealers
pushed for legislation to exempt swaps and OTC derivatives from the CEA.
The futures exchanges at first objected, claiming that equity swaps were in
essence single stock futures. Later, the futures exchanges realized that the
upcoming need to pass legislation to authorize the CFTC provided them
with a vehicle to push for lifting the stock futures prohibition. Hence, they
agreed to support the OTC dealers if the Accord’s prohibition on stock fu-
tures were lifted. Congress turned to both these issues when it began the
process of enacting legislation to reauthorize the CFTC in 1999.

As in 1982, when Congress considered the jurisdictional issues involv-
ing stock futures, there was disagreement in 1999 between the securities
markets and the futures markets as to how stock futures should be regu-
lated. The futures markets wanted stock futures to be regulated like other futures, except for a few securities law provisions such as a prohibition against insider trading. The securities markets objected because stock futures are in essence just a surrogate for highly leveraged stock. In light of the regulatory disparities between securities regulation and futures regulation, a lifting of the prohibition against stock futures without addressing the disparities would subject the markets trading securities, and particularly stock options, to substantial competitive disadvantages and could have a dramatic effect on the stock market. During consideration by Congress of
the CFMA, the securities markets insisted that if the prohibition on stock futures were lifted, the securities markets and the futures markets must operate on a level playing field. The securities markets were concerned that the law in effect prior to the enactment of the CFMA gave more favorable treatment to the products traded at futures exchanges, as compared with those traded at securities exchanges, in areas such as margin requirements, tax treatment, and transaction fees. Because stock futures can be used to perform many of the same functions as equity options, the securities exchanges did not want the law to create artificial incentives for investors to use stock futures as opposed to equity options. The President’s Working Group on Financial Markets (“Working Group”) issued a report that agreed with the views of the securities markets.9 The Working Group’s report at page 39 stated that the prohibitions on stock futures could be lifted “if issues about the integrity of the underlying securities market and regulatory arbitrage are resolved.”

The SEC and CFTC attempted to address the regulatory disparities issues. They issued a joint letter in March 2000 that laid out the skeleton of a system of dual regulation of stock futures.10 The agriculture committees in Congress were impatient for the regulators to fill in the details of the SEC and CFTC system, so they introduced legislation in June 2000. The legislation would have ignored the SEC/CFTC agreement and instead treated stock futures primarily as futures subject to the CEA, with SEC involvement limited to several discrete areas. The House Commerce Committee markup of the bill (“H.R.4541”) completely revised the stock futures portion and inserted an SEC version that instituted a full system of dual regulation for the product. Although changes in certain respects were made to H.R. 4541 as it wound its way through the legislative process, the CFMA largely adopted the version of H.R. 4541 that emerged from the Commerce Committee.

II. ANALYSIS OF STOCK FUTURES PROVISIONS IN CFMA

The CFMA lifts the prohibition on single-stock futures and narrow-based stock index futures and allows these futures to be traded under a system of joint regulation by the SEC and the CFTC. It does this by amending both the CEA and the federal securities laws. The CFMA amends certain

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10 Letter dated March 2, 2000, from Arthur Levitt, Chairman, SEC, and William J. Rauner, Chairman, CFTC, to the Honorable Richard Lugar, Chairman, Senate Agriculture, Nutrition & Forestry Committee and The Honorable Phil Gramm, Chairman, Senate Banking Committee.
definitions under the Securities Exchange Act of 1934 ("1934 Act"). It defines the term "security future" to mean a contract of sale for future delivery of a single security or of a narrow-based security index, and it provides that security futures are included in the definition of "equity security."\(^{11}\)

The CFMA rewrites important jurisdictional provisions in the CEA. An exception to the general rule that the CFTC has exclusive jurisdiction over all futures contracts is made in the case of security futures. In addition, the SEC is granted "jurisdiction and authority over security futures" notwithstanding any other provision of the CEA.\(^{12}\) As a result of this legislation, the CFTC and the SEC have concurrent jurisdiction over single-stock futures and narrow-based index futures.\(^{13}\) The CFTC retains exclusive jurisdiction over "broad-based" stock index futures contracts, i.e. futures on a stock index that is not a "narrow-based security index."\(^{14}\)

Under the CFMA, stock futures can be traded at both securities exchanges and at futures exchanges, and exchanges that trade stock futures must be registered with both the SEC and the CFTC.\(^{15}\) CFTC-regulated exchanges that fall within the statutory definition of "exchange" in the 1934 Act solely by reason of trading stock futures can file a notice registration with the SEC that is effective immediately upon submission of the required information.\(^{16}\) Similarly, national securities exchanges registered with the SEC may be designated as contract markets in stock futures through an expedited notice registration with the CFTC if stock futures are the only futures contracts traded by such exchange. The designation is effective

\(^{11}\) CFMA § 201 (codified at 15 U.S.C. §§ 78c(a)(11) and (55) (2001)).


\(^{13}\) The term "narrow-based security index" is defined to mean an index that satisfies any one of the following criteria:

1. The index has nine or fewer component securities;
2. One security comprises more than 30% of the index’s weighting;
3. The five highest weighted component securities in the aggregate comprise more than 60% of the index’s weighting; or
4. The bottom quartile of the component securities has a combined average daily trading volume of less than $50 million, or $30 million if the index includes at least fifteen securities.

In certain particular circumstances, an index will not be treated as a "narrow-based security index" even though it met one of the above criteria. CFMA § 201 (codified at 15 U.S.C. § 78c(a)(55)(B)).


\(^{15}\) In order to be eligible to trade stock futures, a futures exchange must either be a designated contract market or a registered derivatives transaction execution facility. CFMA § 251, codified at 7 U.S.C. § 2a. In other words, an exempt board of trade that is not subject to CFTC regulation cannot trade stock futures.

\(^{16}\) CFMA § 202, codified at 15 U.S.C. § 78ff(g)
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immediately upon the submission of notice to the CFTC containing the information prescribed by the CFTC.¹⁷

Thus, a security or futures exchange can select its primary regulator as either the SEC or the CFTC for stock futures. If a securities exchange selects the SEC, it will be regulated primarily as a securities exchange, but will be subject to CEA provisions in important areas, described below. Similarly, a futures exchange desiring to be regulated primarily under the CEA can do so, but will be subject to important 1934 Act provisions. A securities exchange could choose the CFTC as its primary regulator as long as it registers as a full contract market with the CFTC and files the "notice registration" with the SEC. The reverse is true for a futures exchange desiring primary regulation by the SEC. The key point is that a market can pick its primary regulator, but will be subject to dual regulation in important areas designed to ensure consistent regulatory treatment regardless of the primary regulator.

With respect to clearing, stock futures may be cleared either by a CFTC-regulated clearing organization or an SEC-regulated clearing agency. A CFTC-regulated clearing organization is not required to register with the SEC solely by reason of clearing stock futures.¹⁸ Similarly, an SEC-regulated clearing agency is not required to register with the CFTC solely by reason of clearing stock futures.¹⁹

The stock index futures contracts currently traded at futures exchanges are required by the CEA to be cash-settled. In contrast, the equity options traded on securities exchanges are physically settled (i.e., shares of the underlying stock are delivered when the option is exercised), while index options are cash-settled. The CFMA does not favor one form of settlement over the other, but instead allows an exchange to choose either form of settlement for stock futures.²⁰

The CFMA requires that the margin requirements for stock futures must be consistent with the margin requirements for comparable options contracts and that the initial and maintenance margin levels for stock futures not be lower than the margin level (exclusive of premium) required for comparable options.²¹ To ensure that the margin rules will be the same for broker-dealers and futures commission merchants ("FCMs") who collect margin from customers on stock futures, the CFMA authorizes the Federal

¹⁷ CFMA § 252.
¹⁸ However, a CFTC-regulated clearing organization must have arrangements in place with an SEC-regulated clearing agency to effect the delivery of the securities underlying the stock futures contract, unless such contract is cash-settled. CFMA § 206 (codified at 15 U.S.C. § 78q-1(b)(7)).
¹⁹ CFMA § 112, adding § 5b(a)(2).
²⁰ CFMA § 206 (codified at 15 U.S.C. § 78f(h)(3)).
Reserve Board to prescribe the margin rules for stock futures or to delegate such authority to the SEC and CFTC acting jointly.\(^2\)

The margin provisions form the core of the dual regulatory structure. Margin is perhaps the feature of an exchange-traded derivative contract with the greatest competitive and regulatory impact. Traditionally, futures markets require much smaller margins than do securities markets. "Margin" is the performance bond required to establish a position in the futures or options markets and the initial down payment in the stock market. Stock index futures margins usually involve five percent or less of the contract value, whereas the Federal Reserve Board establishes a fifty percent margin requirement for stock transactions. For securities options, purchasers must pay the full purchase price, while sellers must put up margin equal to the premium plus fifteen percent for options on broad-based indexes, and the premium plus twenty percent for options on stocks or narrow-based indexes. The reason for the difference in margin between stock index futures and stock index options lies primarily in the fact that the securities options margin is overseen by the SEC, while the stock index futures margin is overseen by the CFTC. The split oversight produced dramatically different margin levels for competing products because of the different regulatory philosophies of the two agencies.

If stock futures were permitted under the same split margin regulation, there would be a significant potential for stock futures margin to differ from the stock options margin. This difference would have a dramatic impact on the competitiveness of options relative to futures. For example, an options writer must pay the premium received plus $4,000 (twenty percent) to establish an options position worth $20,000. If stock futures margin were only ten percent (double the amount for stock index futures), a futures trader need only put up $2,000 to establish an equivalent futures position. This would make the stock option, all other things being equal, at least twice as expensive as a comparable futures contract. To avoid this disparity, the CFMA makes clear that stock futures initial and maintenance margin levels cannot be lower than margin levels for comparable stock options. At current stock options margin levels, this translates into initial and maintenance stock futures margin levels of twenty percent of the contract value for both speculators and hedgers in stock futures contracts. Moreover, to prevent other facets of margin regulation from creating disparities between stock options and stock futures, the CFMA requires that all other areas of margin requirements be comparable between stock futures and stock options. These other areas include, for example, the nature and adequacy of


The Federal Reserve Board subsequently delegated this authority to the SEC and CFTC on March 6, 2001. Letter dated March 6, 2001, from Jennifer J. Johnson, Secretary, Board of Governors of the Federal Reserve System to James E. Newsome, Acting Chairman, CFTC, and Laura S. Unger, Acting Chairman, SEC.
collateral posted for margin and the instruments permitted to act as margin offsets to the option and futures positions.

A separate law amended the Internal Revenue Code to specify the tax treatment for stock futures. As with margin, the tax treatment of stock futures versus stock options has a direct impact on the competitiveness of the products. Prior to the CFMA, all futures contracts received favorable sixty/fifty tax treatment (sixty percent long-term treatment, forty percent short-term treatment). For securities options, only broad-based index options received favorable sixty/fifty treatment for all participants. Stock options and narrow-based index options were taxed 100 percent at short-term rates except for options market makers, who receive sixty/fifty treatment. Thus, if stock futures were taxed like other futures, customers would have an incentive to use futures rather than options solely for tax reasons.

To prevent competitive differences in tax treatment between stock futures and stock options, customer gains or losses in stock futures transactions are treated as short-term capital gains or losses, which is consistent with the tax treatment afforded to customers who buy and sell equity options or the underlying stocks. If the transaction in stock futures is effected for the account of someone who qualifies as a "dealer" in security futures contracts, gains and losses are treated as sixty percent long-term capital gain or loss and forty percent short-term capital gain or loss. A person will be treated as a dealer for this purpose if the Treasury Department passes regulations that determine that such person performs, with respect to the stock futures at issue, functions similar to market-makers in listed options. All such dealer transactions are marked for the market at the end of the tax year and taxable as of that time even if the position remains open. It is important that the definition of "dealer" in security futures contracts in the Treasury regulations be sufficiently narrow so as to include only those futures "locals" that provide liquidity on a regular or continuous basis, which is the key attribute of options market makers.

Another regulatory disparity between stock options and futures handled by the CFMA involves federal transaction fees. All securities transactions are subject to a federal transaction fee pursuant to Section 31 of the 1934 Act. This includes stock options transactions, which are assessed based on the value of the premium. Futures are not subject to a comparable

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23 The provisions for the tax treatment of security futures were enacted as part of the Community Renewal Tax Relief Act of 2000 (codified at 26 U.S.C. §§ 1234B and 1256(g)).

24 As stated by Senator Lugar, the tax treatment of stock futures "would be comparable to the tax treatment of options on securities to ensure a level playing field between the markets." Lugar Remarks at S 11926.

25 Treasury is directed to pass regulations defining security futures dealer not later than July 1, 2001. See H.R.5662, Title IV-Tax Treatment of Securities Futures Contracts. The Treasury solicited comments on the definition of security dealer, but as of the date of this article, has not passed final rules. See 66 Fed. Reg. 13836 (March 7, 2001).
federal transaction fee. The CFMA designates stock futures as securities so that they would be subject to a Section 31 fee. Because futures do not involve a premium as do options, the transaction fee assessments on stock futures transactions will initially be set at $0.02 for each round-turn transaction. This fee is the same regardless of whether the transaction is executed on a securities exchange or a futures exchange.

III. RESOLUTION OF REGULATORY ISSUES

As noted above, stock futures are treated both as futures contracts subject to the CEA and as securities subject to the federal securities laws. This means that a person committing fraud or manipulation in connection with the purchase or sale of stock futures could be prosecuted under both laws. The CFMA amended Sections 9(b), 9(g), 20(d) and 21A(a)(1) of the 1934 Act, which relate to the trading of options and their underlying securities, so that the prohibitions against manipulation and other wrongful activities expressly apply to stock futures. In addition, Section 16 of the 1934 Act was amended to clarify that its provisions regarding short-swing profits by corporate insiders apply to transactions in stock futures.

The CFMA requires that stock futures have listing standards that are substantially identical to listed stock options. For example, the listing standards of a securities exchange requires that only a broker or dealer subject to suitability rules comparable to those of the National Association of Securities Dealers (“NASDAQ”) may effect transactions in stock futures. Similarly, the listing standards of a futures exchange must require that only FCMs subject to suitability rules comparable to those of the NASD may solicit, accept any order for, or otherwise deal in any transaction in connection with stock futures.

Rule changes of futures exchanges that file a notice registration with the SEC are subject to varying degrees of SEC review depending on the subject of the rule change:

- Rule changes relating to margin (except those raising margin levels) require full SEC review and approval under Section 19(b)(2) of the 1934 Act.
- Rule changes relating to higher margin levels, fraud or manipulation, recordkeeping, reporting, listing standards or deci-

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27 CFMA § 205 (codified at 15 U.S.C. §§ 78i(b), 78i(g), 78t(d) and 78o-1(a)(1)).
30 The NASD has heightened suitability rules for options. Presumably, the options suitability rules (rather than the regular securities suitability rules) would apply to stock futures.
mal pricing for security futures products; sales practices for security futures products; or rules effectuating the exchange's obligation to enforce the securities laws must be filed with the SEC under the provisions of new Section 19(b)(7). Such rules changes must be filed concurrently with the CFTC. The futures exchange can put such rule changes into effect as soon as they are approved by the CFTC or are otherwise permitted to go into effect under applicable CFTC regulations. The SEC can abrogate such a rule change within sixty days if, after consulting with the CFTC, the SEC determines that such a rule change unduly burdens competition, conflicts with the securities laws, or is inconsistent with the public interest and the protection of investors. If the futures exchange wishes to refile an abrogated rule change, it must do so pursuant to the normal notice and comment provisions of Section 19(b)(2).

- Rule changes relating to subjects other than those listed above are exempt from SEC review.31

When the SEC is the primary regulator for a securities exchange, the exchange must file all of its rule changes with the SEC. The SEC is required to consult with and consider the views of the CFTC prior to approving or disapproving a proposed rule change filed by a securities market that primarily concerns conduct related to transactions in security futures. If the CFTC comments in writing on such a rule, the SEC must respond in writing to such comments before approving or disapproving the rule. If the CFTC notifies the SEC that such rule would adversely effect the liquidity or efficiency of the market for security futures or impose a burden on competition not necessary or appropriate, the SEC can still approve the rule, but only if it finds that such rule is necessary and appropriate in furtherance of the purposes of Section 19 of the 1934 Act notwithstanding the CFTC's determination.32 It is important to recognize that, even with those provisions, the rule review process for securities-based stock futures exchanges will be far more burdensome than for commodities-based stock futures exchanges. The CFTC merely requires a short certification by a contract market that is changing a rule and does not conduct any review of the rule change. In contrast, the SEC requires its exchanges to file a detailed form explaining the basis for a proposed rule change. The SEC conducts a full review of every proposed rule change and its approval is required for most exchange rule changes. Hence, a securities-based exchange will have all of its rule changes subjected to the more lengthy SEC review process, while a com-

31 CFMA § 202 (codified at 15 U.S.C. § 78s(b)(7)).
32 CFMA § 202 (codified at 15 U.S.C. § 78s(b)(9)).
modities-based exchange will only have a small category of rules subjected to SEC review.

Under the CEA, as amended by the CFMA, prior CFTC approval is not needed for rule changes by futures exchanges, except for those that amend the terms and conditions of agricultural contracts that have been listed for trading and have open interest. Accordingly, neither traditional futures exchanges nor securities exchanges that file a notice registration with the CFTC are required to obtain prior CFTC approval of their rule changes.  

IV. MINIMIZING REGULATORY OVELAP AND DUPLICATION

Having stock futures governed by both the CEA and the federal securities laws creates a risk of overregulation because all of the regulatory requirements from one statutory scheme are added on top of the requirements from the other statutory scheme. Market intermediaries in particular were concerned that they could become subject to duplicative, and possibly conflicting, regulatory mandates. The CFMA attempts to minimize overlapping and duplicative regulation in a number of areas.

The CFMA provides for expedited SEC notice registration of CFTC-registered FCMs and introducing brokers that would fall within the statutory definition of the terms “broker” or “dealer” solely by reason of effecting transactions in security futures. Broker-dealers that limit their securities business to transactions in security futures are exempted from certain specified sections of the 1934 Act and are also exempted from the requirement to join the Securities Investor Protection Corporation. Floor brokers and floor traders at futures exchanges are exempted from the requirement to register as a broker-dealer.  The CFMA also provides for expedited CFTC notice registration of securities broker-dealers that would fall within the statutory definition of the terms “futures commission merchant” or “introducing broker” solely by reason of effecting transactions in security futures. Broker-dealers who act as a floor broker or floor trader are exempted from registering as such with the CFTC if they confine their activities in futures to security futures.  

The SEC and CFTC, in consultation with each other, are directed to issue such rules, regulations, or orders as are necessary to avoid duplicative or conflicting regulations applicable to broker-dealers and FCMs with respect to the treatment of customer funds, securities, maintenance of books and records, financial reporting, or other financial responsibility rules involving security futures. Securities exchanges, national securities associations, futures exchanges and national futures associations are similarly

33 CFMA § 113.
34 CFMA § 203 (codified at 15 U.S.C. §§ 78o(b)(11)-(12)).
35 CFMA § 252 (codified at 7 U.S.C. § 6f(a)).
36 CFMA § 206 (codified at 15 U.S.C. § 78o(e)(3)).
directed to adopt rules in order to prevent duplicative regulation of firms with respect to financial responsibility rules involving security futures.\textsuperscript{37}

The CFMA creates a new category of registrant known as a "limited purpose national securities association." It is expected that the National Futures Association ("NFA") will become a registered national securities association for the limited purpose of regulating the activities of its members who act as brokers or dealers in security futures. Futures market intermediaries that register as broker dealers solely because of their security futures activities are not required to join the NASD if they are members of NFA.\textsuperscript{38} Similarly, a broker-dealer that files a notice registration with the CFTC must be a member of the NASD, but is not required to become a member of NFA.\textsuperscript{39}

Persons or entities who are registered with either the SEC or the CFTC, and who are required to register with the other agency solely because of their activities with respect to security futures, are referred to as "notice registrants." The CFMA directs the SEC to cooperate with the CFTC in connection with the SEC’s proposed examinations of notice registrants. The SEC must notify the CFTC of such proposed examination and consult with the CFTC concerning the feasibility and desirability of coordinating such examination with examinations conducted by the CFTC in order to avoid unnecessary duplication or undue regulatory burdens. Before conducting such an examination, the SEC must make use of reports and other information available from the CFTC. If the SEC nonetheless conducts such an examination, it must notify the CFTC and, upon request, furnish to the CFTC any report prepared by the SEC in connection with such examination.\textsuperscript{40} The CFMA imposes substantially the same requirements on the CFTC in connection with a CFTC examination of notice registrants.\textsuperscript{41}

If the SEC brings an enforcement proceeding against a notice registrant, it must provide the CFTC with notice of the commencement of such proceeding and a copy of any order entered by the SEC in such a proceeding.\textsuperscript{42} The CFTC is required to notify the SEC of the commencement of any proceeding brought against a notice registrant.\textsuperscript{43} The CFMA also amended the CEA to provide that the CFTC’s authority to investigate the cash markets underlying futures contracts shall not apply to investigations involving any security underlying a security futures product.\textsuperscript{44}

\textsuperscript{37} CFMA § 206 (codified at 15 U.S.C. § 78f and 78o-3(1)).
\textsuperscript{38} CFMA § 203 (codified at 15 U.S.C. § 78o-3(k)).
\textsuperscript{39} CFMA § 252 (codified at 7 U.S.C. § 6f(a)).
\textsuperscript{40} CFMA § 204 (codified at 15 U.S.C. § 78q(b)).
\textsuperscript{41} CFMA § 251 (codified at 7 U.S.C. § 2a).
\textsuperscript{42} CFMA § 205 (codified at 7 U.S.C. § 78u).
\textsuperscript{43} CFMA § 253 (codified at 7 U.S.C. §§ 12(a) and 13a-1(h)).
\textsuperscript{44} CFMA § 251 (codified at 7 U.S.C. § 20).
V. THE PROCESS MOVING AHEAD

The stock futures provisions of the CFMA are quite lengthy – over 100 pages of legislative text. The SEC and the CFTC will have to pass dual regulations in many areas to implement the bill, and Treasury will have to pass regulations for its tax treatment. Moreover, there are many important regulatory issues still left unresolved. For example, the securities options markets are subject to common clearing under one clearing agency, The Options Clearing Corporation. In contrast, each futures exchange operates its own captive clearing corporation for products traded on that exchange. The CFMA equivocates on which system (or hybrid of systems) to use for stock futures. Each stock futures exchange could choose to use common clearing or its own affiliated clearing agency. The CFMA requires that, after two years of trading stock futures or 180 days after stock futures volume equals ten percent of stock options volume, whichever is later, there would have to be linked and coordinated clearing for stock futures unless the SEC and CFTC determine otherwise. Similarly, stock futures markets will only be subject to the national market system provisions of Section 11A of the 1934 (e.g., consolidated quote and transaction tape) if and when and the SEC and the CFTC jointly agree to apply these provisions to stock futures.

I believe the failure of the two agencies to agree on whether the common clearing and national market system provisions covering the securities options markets apply to stock futures at the outset of trading is due to the limited time period the agencies had to analyze these issues. After the two agencies issued their preliminary plans for joint regulation in March 2001, the Agriculture Committees in Congress gave them only these months to resolve all the issues. It is no surprise that the two agencies had to defer final action on some of the more contentious issues. Had the agencies conducted a joint study on stock futures in the 1980s as they had agreed as a result of the Accord, they would have confronted these issues in a more studious and measured way.

The regulatory structure produced by the CFMA is complicated, but necessarily so in order to ensure adequate dual regulation. While it should provide a level, competitive playing field for the introduction and trading of stock futures, the structure is not ideal. The bifurcated structure emanates from the anachronistic system of split jurisdiction of equity products between the SEC and CFTC.

The United States is virtually unique in the world in respect to its regulatory structure of the equity markets. No other major equity market is subject to a complete split of regulatory jurisdiction between the securities markets and the securities futures markets. There always is one regulatory authority ultimately responsible for all the equity markets.

This anomalous system in the United States always had its weakest stress point at stock futures. These instruments, for all intents and purposes, are securities. There is no rational reason to call a stock option a security
but not a stock future. Yet, because it is called a “future,” the commodities interests have fought against regulating stock futures simply as securities. Thus, to lift the prohibition in the Accord, it was necessary for the SEC and CFTC to acquiesce in a shared system of jurisdiction.

The CFMA attempts to rationalize the shared jurisdiction by providing for notice registrations, minimizing regulatory duplication when possible, and establishing consistent treatment in key areas between stock options and stock futures. To make the structure operate smoothly, the SEC and the CFTC will have to work together on common rules and interpretations as well as surveillance and enforcement oversight. This could pose some interesting challenges for the two agencies. The SEC’s traditional focus on investor protection and full disclosure is different from the CFTC’s emphasis on facilitating price discovery and commercial hedging. The ability of the two agencies to cooperate and fulfill the mandates of the CFMA will be particularly tested as the agencies fill in the specifics of the regulatory structure through rulemaking.

As an active participant in the legislative process of the CFMA, I know it was a high priority of Congress to ensure identical regulatory treatment for stock options and stock futures. As the agencies adopt dual rulemaking over the coming year in such key areas as margin and (for Treasury) tax treatment, it will be crucial to keep regulatory consistency as the touchstone for their efforts. Otherwise, the CFMA structure will splinter into the troublesome bifurcated system that exists for all other equity products.

Of course, it would be easier if there were only one regulator of stock futures through a merger of the SEC and CFTC. That would provide unified oversight over stocks, stock options, and stock futures. It is unlikely in the near term that Congress will acquire the political will to do so. The House of Representatives recently consolidated oversight of most securities and banking activities into the Financial Services Committee, similar to the consolidated oversight in the Senate Banking Committee. Both the House and Senate, however, continued to maintain separate oversight of the CFTC in their respective agriculture committees. Consequently, the jerry-rigged structure of the CFMA will have to suffice. Thus, on December 20, 2000, with the start of full-scale stock futures trading, the long and winding road that began with the Accord in 1982 will have come to the conclusion of the first part of the journey. With the bifurcated regulatory system, however, the road will still meander onwards.

45 As of the date of this article, the SEC and CFTC had proposed, and in most cases adopted, rules to implement various provisions of the CFMA regarding stock futures. See, e.g., Securities Exchange Act Release No. 44724 (August 21, 2001). Interestingly, the agencies had not yet proposed rules concerning the margin treatment of stock futures.