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# **The Regulation of Global Futures Markets: Is Harmonization Possible or Even Desirable?**

*Jane C. Kang\**

## INTRODUCTION

The February 1995 collapse of the British merchant bank, Barings Plc, and the announcement in June 1996 by the Sumitomo Corporation of copper trading losses in excess of 2 billion dollars are only two of the more recent events underscoring the global complexity of financial markets today. The failure of Barings resulted from unhedged proprietary positions in the Nikkei 225 on the Singapore International Monetary Exchange (SIMEX) and the Osaka Stock Exchange. This precipitated actions by financial regulatory and market authorities in Singapore, Japan, Hong Kong, the United Kingdom, and the United States. The events surrounding Sumitomo spanned three jurisdictions: the United Kingdom, where Sumitomo was trading on the London Metal Exchange (LME), the United States, where the LME recently had established a warehouse for delivery of copper (and where copper is traded on the New York Mercantile Exchange), and Japan, where Sumitomo is legally domiciled.

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Today, derivative products<sup>1</sup> trade around the clock and around the globe, on and off exchange, on screen-based trading systems and in open outcry pits, and through international linkage arrangements involving both screen systems and floor systems. Between 1986 and 1995, world futures volume increased 650% with a corresponding increase in geographic diversity.<sup>2</sup> In 1995, the ten most active exchanges were located in five countries—Brazil, France, Germany, the United Kingdom, and the United States.

Recently, the move toward more free market economies in Eastern Europe, Asia, and Latin America has promoted the development of capital markets, and futures and options exchanges to assist in the transition. Since 1990, over 20 futures exchanges have begun operation in Africa, Eastern Europe, Asia, and Latin America.

There is also increasing competition among the established international markets for volume in the same or related products. For example, the Nikkei 225 material, in respect to Barings above, trades not only on the Osaka Stock Exchange and SIMEX, but also on the Chicago Mercantile Exchange (CME). Other examples include the German Bund, which is traded on the London International Financial and Futures and Options Exchange (LIFFE), the German Deutsche

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<sup>1</sup> A derivative instrument, broadly defined, is a contract whose value is derived from or is dependent on one or more underlying assets or indexes. Derivatives can include a wide assortment of financial contracts, including forwards, futures, swaps, and options. The primary economic function of derivatives is the transfer of market risk resulting from an adverse change in the price of an asset or portfolio of assets. By their nature, such instruments can be highly leveraged, and therefore, highly risky. Derivatives are entered throughout the world on organized exchanges, in which case they are generally standardized as to maturity, contract size and delivery terms, and over-the-counter (OTC), which are products tailored to meet a particular institution's risk hedging needs.

The OTC derivatives marketplace does not consist of a distinct category of products having common characteristics, and there are no agreed standards, minimum or otherwise, applicable to all such products. See COMMODITY FUTURES TRADING COMMISSION, *OTC DERIVATIVE MARKETS AND THEIR REGULATION*, at 87 (Oct. 1993). The regulatory treatment of OTC derivatives raises a variety of issues which are beyond the subject of this article, which is concerned primarily with exchange-traded futures and commodity options contracts. For ease of reference, such exchanges are referred to herein as "futures exchanges" or "futures markets."

<sup>2</sup> Unless otherwise specified, technical data and volume information contained in this article are derived from the following sources:

FUTURES INDUSTRY ASSOCIATION (FIA) INT'L REPORT, *INTERNATIONAL VOLUME AND OPEN INTEREST REPORT* (1986-1995).

COMMODITY FUTURES TRADING COMMISSION, *INTERNATIONAL REGULATION OF DERIVATIVE MARKETS, PRODUCTS AND FINANCIAL INTERMEDIARIES* (1996)[hereinafter Collated Summary].

COMMODITY FUTURES TRADING COMMISSION, *EMERGING MARKET DATABASE* (1996).

COMMODITY FUTURES TRADING COMMISSION, *A STUDY OF THE GLOBAL COMPETITIVENESS OF U.S. FUTURES MARKETS* (April 1994)[hereinafter Competitiveness Study].

Terminbourse (DTB) and the Chicago Board of Trade (CBOT), and the Euroyen, which is traded on the Tokyo International Financial Futures Exchange (TIFFE), SIMEX and CME. Many of the world commodities such as metals, grains, coffee and oil similarly trade on markets in many different jurisdictions.

At the same time that markets attracting international investor interest are becoming more dispersed geographically and increasingly offering similar or related products, risk is being concentrated in fewer financial intermediaries and market users. Competitive forces and the changing business climate are leading to a consolidation in the number of firms providing an intermediation service for futures transactions. This trend has been accompanied by the market dominance of institutional investors who have the means and the capital to access international markets.

These increasing linkages between the world's financial markets and market participants and their implications for systemic risk have been recognized and commented on at the highest levels of government. At their recent 22nd annual meeting, the leaders of the G7 countries in their communique noted the opportunities and challenges presented by the increased integration of global capital markets.<sup>3</sup> They endorsed the implementation of improved practical measures to deal with risks posed by the operation of global financial markets, including enhancing cooperation among international financial regulatory authorities, promoting stronger risk management and improving transparency in market operations. They particularly encouraged the adoption of strong prudential standards in emerging economies and encouraged all relevant bodies to increase efforts to promote effective supervisory structures in these economies.<sup>4</sup>

#### I. REGULATORY HARMONIZATION VS. REGULATORY COMPETITION: HOW BEST TO ENHANCE REGULATORY PROTECTIONS IN GLOBAL FUTURES MARKET

The proliferation of futures markets raises important questions concerning the structure of international regulatory systems intended to safeguard those markets. Although international regulators can usually agree on the basic goals and objectives of regulation, there exists fundamental differences in the regulatory approach taken, in-

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<sup>3</sup> See G7 ECONOMIC COMMUNIQUE, MAKING A SUCCESS OF GLOBALIZATION FOR THE BENEFIT OF ALL (June 28, 1996)[hereinafter Lyon Communique]. The G7 countries are Canada, Italy, France, Germany, Japan, the United States, and United Kingdom.

<sup>4</sup> *Id.* at §§10-12.

cluding the form and content of regulation. Should such systems be harmonized to ensure uniformity of regulatory protection and to prevent the competition for market share resulting in the lowest common denominator of regulation, in effect, causing a race to the bottom? Or, should diversity among international systems be accepted and, indeed, encouraged to ensure that regulation, in addition to being responsible, is innovative and responsive to different and evolving market and business conditions?

Markets and regulators alike are well aware of the consequences of reputational damage and the difficulty of restoring confidence after a market or regulatory failure. The recent suspension by the Philippine Securities and Exchange Commission of the registration of the Manila International Futures Exchange (MIFE) based on findings of massive fraud perpetrated on customers will cause customers to be wary about re-entering the market, if and when it reopens.<sup>5</sup> A less dramatic example, but one with far reaching consequences to this day<sup>6</sup> is the tin crisis of 1985. Because it occurred coincident with the implementation of the U.K. Financial Services Act 1986, the LME had little option but to restructure as a U.K. Recognised Investment Exchange (RIE). It also had to join, for the first time, the U.K. clearing house, at that time the International Commodity Clearing House, now known as the London Clearing House (LCH). Indeed, as this article will later highlight, events have proven that no system, however well-established, is immune from real or perceived regulatory failures or failings.

Although concerned with reputational risk, national policy makers and market developers may well put a higher priority on launching a market or product "on schedule," than on providing a robust regulatory system. Thus, in the race to become the first exchange to introduce a product, many emerging markets and their regulators find themselves in the unenviable position of choosing between:

- reputational risk, a potential consequence of accelerating the commencement of market operations with an underdeveloped or inadequate financial infrastructure, ranging from regulatory concerns such as proper accounting standards and banking systems to support such

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<sup>5</sup> SEC Closes MIFE, *BUSINESS WORLD*, June 24, 1996.

<sup>6</sup> Following the Sumitomo disclosure and in view of the many unique features of metals trading on the LME, the Exchange was the subject of a review by its oversight authority, the UK Securities and Investments Board (SIB), which issued a Consultative Document seeking public comment on the adequacy of the current regulatory arrangement. UK SIB, *A REVIEW OF THE METALS MARKET* (August 15, 1996)[hereinafter LME Review].

operations to technological considerations impacting on their operational capacity, such as a viable telecommunications system, and

- market share risk, the concern other more mature liquid markets or less prudent jurisdictions, particularly those in the same time zone, will initiate trading in that contract and volume may never migrate back home.<sup>7</sup>

Mature market jurisdictions face equally complex issues in launching market and product innovations with previously unknown systemic and other risk attributes. If regulators are perceived as too cautious, they may be accused of not providing a level playing field on which their regulated markets and firms can compete with other global markets or global firms.<sup>8</sup>

The view often is advanced that harmonization or standardization of regulatory requirements would enhance protection and level the global playing field in the competition for market share and customer business. Those who favor regulatory competition wonder instead whether harmonization could lead to inefficient, ineffective and costly regulation without any corresponding regulatory benefit. This article offers a regulatory practitioner's view that the effective regulation of international markets and market participants need not be framed as a stark choice between regulatory harmonization and regulatory competition.<sup>9</sup>

Described below is the diversity of major international approaches in effect today, including their scope, content and implementation. This article not only highlights the complexities of achieving harmonization but also questions whether harmonization would be desirable. Among other reasons, in view of fundamental differences in the legal, cultural and business conditions of different jurisdictions, no one system is likely to work across all jurisdictions. Moreover, very different approaches can lead to equally successful results. It further notes that a byproduct of competition, regulatory diversity, provides the basis for regulatory "benchmarking" and facilitates the development of more innovative, efficient and less costly regulations.

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<sup>7</sup> Merton H. Miller, *International Competitiveness of U.S. Futures Exchanges*, 4 J. FIN. SERV. RES. 387, 389 (1990).

<sup>8</sup> Pat Arbor, chairman of the CBOT recently stated, "The United States futures industry is not afraid of competition. We welcome it. We just don't think we should have one hand tied behind our back while we compete." Pat Arbor, *Mission Impossible?*, FUTURES AND OPTIONS WORLD, August 1996, at 5.

<sup>9</sup> See Larry White, *Competition versus Harmonization - An Overview of International Regulation of Financial Services*, INTERNATIONAL FINANCIAL MARKETS 6 (Claude E. Barfield ed., 1996).

However, even diversity must have its limits. In an increasingly integrated global marketplace, the consequences of a major regulatory failure may be too costly to endorse differing regulatory approaches which do not have as a minimum the achievement of certain agreed principles, standards and practices. This article will note some major trends in the evolution of regulation of global markets which help explain why regulatory diversity is evolving within the framework of agreed "rules of the game" and provide support for the view that existing regulatory regimes are converging towards internationally accepted standards of regulation.

Ultimately, risk cannot be regulated out of the system and the challenge for national policy makers and regulators is to achieve a balance between prudent regulation and acceptable levels of risk that is appropriate for their jurisdiction.

## II. REGULATORY DIVERSITY

The basic aim of all derivatives regulation is to control the risks associated with the regulated conduct. In the case of exchange-traded futures transactions, those risks include systemic risk, market risk, broker risk and client risk,<sup>10</sup> which are addressed by rules governing market integrity and efficiency, financial safety and integrity and fairness.<sup>11</sup>

A review of current regulatory systems reveals deep philosophical differences in approaches to regulation and indeed there is no preferred regulatory approach or any system which is universally acknowledged as encompassing the best approach.<sup>12</sup>

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<sup>10</sup> Phillip A. Thorpe, *Regulation of Futures Markets in the United Kingdom*, in *REGULATING INTERNATIONAL FINANCIAL MARKETS: ISSUES AND POLICIES* 151, 169 (Franklin R. Edwards and Hugh T. Patrick eds., 1992).

<sup>11</sup> See, e.g., Collated Summary, *supra* note 2, at 3. Collated Summary was originally published as a document of the Technical Committee (TC) of the International Organization of Securities Commissions (IOSCO) in June 1990. Since that date, the document has been updated on an annual basis by the CFTC.

IOSCO's TC consists of securities and derivatives regulators from over 70 jurisdictions. It was created in May 1987 to review regulatory problems related to international security transactions and to propose practical solutions to these problems. Current members include regulatory authorities from Australia, France, Germany, Hong Kong, Italy, Japan, Mexico, the Netherlands, Ontario, Quebec, Spain, Sweden, Switzerland, the United Kingdom and the United States.

<sup>12</sup> See Collated Summary, *supra* note 2, at 2.

### A. Philosophical Differences

Philosophical differences in approaches to regulation involve several fundamental issues: to whom do the regulations apply, which rules apply and when do they apply?

Some jurisdictions cast a wide net, mandating that every act or transaction which involves "conduct in" or "contact with" that jurisdiction, whether territorial or with their residents and citizens, falls within their regulatory jurisdiction. In the scope and implementation of their regulatory and enforcement powers, such systems generally have decided not to be constrained by sovereignty or resource considerations,<sup>13</sup> nor does it matter that the transaction at issue was "solicited" or "unsolicited." Other jurisdictions, to a significant degree, rely on territorial distinctions in determining which of their rules will apply and to whom. In some jurisdictions, residents who on an unsolicited basis engage in investment business with a firm in another jurisdiction are presumed to have accepted the risk of such transactions, and they are not afforded the protection of their jurisdictions' regulatory systems. The Investment Services Directive (ISD) of the European Community (EC) and its home/host state distinctions as to which jurisdiction's laws will apply is another example of how regulatory regimes deal with territorial concerns.<sup>14</sup>

Another area where significant differences occur is the extent to which regulatory authorities distinguish between different types of customers in the application of their regulatory regimes. In some jurisdictions, the rules intended to address "fairness" or conduct of business—including disclosure, best execution, account documentation such as confirmation statements and monthly reports and, in some cases, protection of client assets—do not apply at all or only in part to professional or sophisticated customers, or they permit customers to

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<sup>13</sup> Judicial requirements, however, may impede them in their assertion of jurisdiction in enforcement proceedings. See Collated Summary, *supra* note 2, at 60-71.

<sup>14</sup> EC member states are Belgium, Denmark, France, Germany, Greece, Ireland, Italy, Luxembourg, the Netherlands, Portugal, Spain and the United Kingdom.

Under the ISD, a firm's home state is the state in which it has its head office and registered office, and whose authorities have granted it an authorization to do business covered by the ISD. A firm's host state is any other state within the EC in which it carries on business covered by its ISD authorization. The basic principle is of home state supervision with the: (1) home member state authorities being responsible for authorization and prudential supervision throughout the EC (including fit and proper requirements (*e.g.*, internal systems and controls), financial resources and client assets); and (2) host member state authorities responsible for establishing and enforcement of conduct of business rules. See UK SIB, IMPLEMENTATION OF THE INVESTMENT SERVICES DIRECTIVE AND CAPITAL ADEQUACY DIRECTIVE (July 1994).



opt out of such protection.<sup>15</sup> This approach is based on the view that such customers have sufficient knowledge of financial instruments and/or financial resources to enable them to make an informed assessment of the risks involved. Other jurisdictions do not make such distinctions in the application of their fairness rules and generally require that the full panoply of their rules apply equally to all customers.<sup>16</sup>

Although this article does not focus on the off-exchange trading of derivatives, this is another area of major difference among jurisdictions. Some jurisdictions believe that subject to certain narrowly defined exemptions or safe harbors, in general, all transactions in futures must be done on an organized, licensed or authorized exchange, in essence, providing an exchange monopoly.<sup>17</sup> When imposed, this requirement is intended to ensure that the markets operate to acceptable standards in matters such as ensuring open and competitive trading, providing continuous markets, protecting against counterparty risk and enhancing transparency through public price dissemination.

Other jurisdictions do not require that all transactions involving derivatives occur on an organized exchange, and still others require they occur on an exchange only when such transactions involve public or retail customers. In many jurisdictions, the rules are silent on the legal status of such transactions. Whether transactions in derivatives must be executed on organized exchanges or not may influence which regulatory measures are employed to address market integrity and efficiency concerns.

## B. Market Integrity and Efficiency

The fundamental purpose of a derivative product is to shift risk. When these products trade on an organized exchange, the markets on which they trade serve another important function—the forces of sup-

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<sup>15</sup> The United Kingdom is one major market jurisdiction which systematically distinguishes between sophisticated and unsophisticated customers in the application of its regulatory system. U.K. conduct of business rules differentiate between “private customers” and “non-private customers.” Collated Summary, *supra* note 2, at 76.

<sup>16</sup> *Id.* at 77.

<sup>17</sup> PHILIP MCBRIDE JOHNSON & THOMAS LEE HAZEN, *COMMODITIES REGULATION* 253 (2d ed. 1989). It should be noted, however, that the Futures Trading Practices Act of 1992, § 502, 106 Stat. 3590 (1992) (amending § 4(a) of the Commodities Exchange Act (CEA), 7 U.S.C. § 6(a), and adding § 4(c)(1), 7 U.S.C. § 6(c)(1), authorizes the CFTC to exempt any agreement, contract or transaction that is otherwise subject to the exchange-trading requirement of § 4(a)). Although the CFTC has adopted a limited pilot program to exempt so-called professional markets from certain CFTC rules otherwise applicable to exchange markets, no exchange has filed for relief under the program. 60 Fed. Reg. 51,323 (1995).

ply and demand in this central forum assist in price discovery in the underlying cash commodity by publicly forecasting traders' future expectations of the price of that commodity. If the design of products traded on the market makes them readily susceptible to manipulation, or if as a result of inadequate surveillance and monitoring, prices on the market can be manipulated, or trading practices are such that a few can benefit at the expense of others, traders will lose confidence in the integrity of the marketplace.

For these reasons, market integrity concerns are central to regulatory programs related to organized futures and options markets. Therefore, most jurisdictions require that futures markets, including the arrangements for the clearance and settlement of contracts, and products be "recognized" or authorized.

The measures used to detect and deter market situations conducive to possible price distortion and abusive trading practices and to limit the adverse effects of market volatility, however, vary from jurisdiction to jurisdiction. These measures include:

- position limits, which restrict the number of positions in a particular contract that one person can control;<sup>18</sup>
- large trader reporting, which requires the reporting to regulators by traders who control more than a certain number of positions;<sup>19</sup>
- front-running restrictions, which prohibit brokers from trading ahead of their customers;
- audit trail requirements, which permit the reconstruction of trades and transactions necessary to allow detection and proof of possible abuses;

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<sup>18</sup> In the United States, such limits are intended to prevent market disruptions. In other jurisdictions, such limits are imposed principally to limit a firm's exposure to a single customer involving a single commodity and not to prevent market manipulation.

<sup>19</sup> CFTC rules require brokers to report the daily futures and options positions of any trader that owns or controls a position in any delivery month of a commodity that equals or exceeds specified reporting levels. The firm also must identify the persons who own or control those reportable positions by name and address. The CFTC also may make special calls on FCMs and foreign brokers carrying accounts for traders with large positions.

Information from the CFTC's large trader data base was invaluable during the market crisis of 1987, the failure of Barings in quickly confirming that the positions of Barings and its related entities on US markets was de minimis, and during the recent Sumitomo crisis in confirming that Sumitomo Corporation had no reportable positions on any US market. Although conceived as a market surveillance tool and in reconstructing market activities, the large trader reporting system is equally important from a systemic risk perspective in monitoring market conditions and the financial and operational viability of relevant firms. See U.S. TREAS., REPORT OF THE PRESIDENTIAL TASK FORCE ON MARKET MECHANISMS (1988)[hereinafter Brady Report].

Although most foreign regulatory authorities have the ability to request information from markets and traders subject to their jurisdiction, and some foreign markets require that their members report the identity of customer and firm position which are at reportable levels, no other major market jurisdiction requires the routine reporting of large positions, either by traders or by brokers to relevant regulatory authorities.

- transparency requirements, that is, the public dissemination of price and volume;<sup>20</sup>
- listing or contract design standards, including restrictions on which products can be the subject of secondary trading and specifications or procedures for contracts providing for physical delivery of an underlying commodity, to ensure that proposed terms and conditions do not have deficiencies that could increase the likelihood of cash, futures, or option market disruptions and undermine the usefulness and efficiency of a market;<sup>21</sup> and
- price limits, circuit breakers and/or trading halts, changes in trading hours, changes in settlement times or payment means or manner of calculating settlement prices, to minimize the adverse effects of unusual market volatility.<sup>22</sup>

As noted above, although all regulatory systems have rules regarding the maintenance of fair and orderly markets, they vary significantly in the degree to which they rely on some or any of the specific measures listed above to achieve such goals. In most jurisdictions, decisions regarding which, if any, of these measures to implement are left to the discretion of the exchange, without any prior approval, implicit or express, required by the regulatory authority. In other jurisdictions, some or all of the measures noted above may be the subject of express regulatory rules established by the governmental authority.

The reason for this variance may rest, in part, on the perceived role or purpose of the market in that jurisdiction, as illustrated by a comparison of the U.S. and U.K. perspectives.<sup>23</sup> In the U.S. statutory

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<sup>20</sup> Most futures and option exchanges provide post-trade price and volume information on a real-time basis to quote vendors (although this may not be required).

The EC's ISD contains transparency requirements (in addition to recordkeeping requirements) applicable to all EC member states. Price and volume information must be published at the beginning of every day, every hour and every twenty minutes. Information about quotes must be available during all periods the market is open. Ruben Lee, *Supervising EU Capital Markets: Do We Need a European SEC?*, in *EUROPEAN ECONOMIC AND BUSINESS LAW* 187, 190 (Buxbaum, Hertig eds., 1996).

<sup>21</sup> An October 1992 IOSCO paper reflected international consensus that exchanges and regulators should take into account certain specified criteria relevant to the underlying index in designing or reviewing a derivative product based on a stock index. These criteria are: (1) the method of calculation; (2) the number of component stocks; (3) the liquidity of component stocks; (4) the dispersion of component stocks; (5) the replacement of component stocks; and (6) the selection of component stocks' clearance and settlement. See IOSCO TECHNICAL COMMITTEE, *REPORT ON CONTRACT DESIGN AND MEASURES TO MINIMIZE MARKET DISRUPTION*, at 2 (Oct. 1992).

<sup>22</sup> See IOSCO TECHNICAL COMMITTEE, *MECHANISMS TO ENHANCE OPEN AND TIMELY COMMUNICATION BETWEEN MARKET AUTHORITIES OF RELATED CASH AND DERIVATIVE MARKETS DURING PERIODS OF MARKET DISRUPTION*, at 11-12 (Oct. 1993).

<sup>23</sup> The approaches implemented by the United States and United Kingdom, which regulate among the most active international futures markets, are frequently referred to in this article for comparative purposes.

framework, the commercial aspects of futures trading and markets implicitly take a secondary role to the public interest, public purpose function they provide relative to hedging against price risk, price discovery and the actual pricing of commercial commodity transactions.<sup>24</sup> Although the exchanges are commercial concerns, they are vested by statute with quasi-governmental responsibilities as self-regulatory organizations (SRO) with the duty to police their members and are accountable to their regulatory oversight authority, the CFTC, for compliance with all of their rules.

Under the U.K. system, the Financial Services Act of 1986 (FSA) specifically does not impose self-regulatory obligations on the markets, recognizing that the London markets evolved from and remain today essentially commercial and user markets.<sup>25</sup> The FSA instead focuses on the protection of the retail investor.<sup>26</sup> Additionally, the FSA has among its objectives, the promotion of the competitiveness and the avoidance of protectionism for the industry it regulates, including futures exchanges.<sup>27</sup>

### C. Financial Integrity Regime

A distinct feature of most organized futures exchanges is that credit risk between the ultimate counterparties (*i.e.*, clearing members) is eliminated through the process of novation.<sup>28</sup> In this setting,

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<sup>24</sup> JOHNSON & HAZEN, *supra* note 17, at 261 (citing 7 U.S.C. §§5, 6(b), (c), (h)).

<sup>25</sup> See Thorpe, *supra* note 10, at 161.

<sup>26</sup> *Id.* at 161.

<sup>27</sup> ANDREW LARGE, FINANCIAL SERVICES REGULATION - MAKING THE TWO TIER SYSTEM WORK, at 20-21 (SIB, May 1993) [hereinafter Large Report].

It should be noted, however, that the 1992 CFTC reauthorization legislation, the Futures Practices Trading Act of 1992 (FPTA), *See* discussion *infra* 36-38, provided for a study by the CFTC of the global competitiveness of U.S. futures markets, resulting in the 1993 Competitiveness Study.

In addition, the Chairman and ranking minority member of the Senate Committee on Agriculture, Nutrition, and Forestry issued a joint statement outlining their planned legislative reforms updating the CEA in which they noted:

There is a public interest in a strong, competitive U.S. futures industry because of its critical role in price discovery and business risk management. This public interest implies, and requires, a degree of regulation. In recent years, U.S. futures exchanges have also faced increasing competition from foreign exchanges and from over-the-counter derivative products. U.S. exchanges face some regulatory costs that are not borne by their competitors. The [CEA], and the [CFTC's] actions to implement its requirements, must strike an appropriate balance between prudent regulation and the need for a cost-competitive industry.

*Reforming and Updating the Commodity Exchange Act: Outline of Planned Legislation* (joint statement of Sen. Lugar and Sen. Leahy, Sen. Com. on Ag., Nutrition and Forestry, Aug. 1996).

<sup>28</sup> This term refers to the legal substitution of a new party and discharge of one of the original parties to a contract by agreement of all three parties. A new contract is created with the

the exchange/clearing house<sup>29</sup> becomes the buyer to every seller and the seller to every buyer.

The exchange minimizes its exposure to its members by marking all positions to the market on a daily basis and settling all trades through pays and collects.<sup>30</sup> The clearing house collects variation margin from the losing side of trades and pays the gaining side of trades on the exchange. If a clearing member is unable to pay the variation margin and defaults, the clearing house guarantees performance on the contract.

Consequently, prudential or financial resource requirements are a key component of all futures market regulations. Such requirements serve to protect markets, firms and customers from default and systemic risk by ensuring that only those who are creditworthy and have a stake in the proper conduct of business have access to markets and to customers funds.

The following key components of financial integrity are discussed below: (1) financial resource requirements; (2) clearance and settlement of trades; (3) margin and credit extension; and (4) protection of clients assets and insolvency.

### *1. Financial Resource Requirements*

Although financial resource requirements for intermediaries are in effect in all jurisdictions and in most cases are based on a measure of increased or decreased liabilities or volume of business, there are jurisdictional differences as to the level of required capital, the man-

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same terms as the original one but only the parties are changed. RESTATEMENT OF CONTRACTS §§ 423-430 (1932).

<sup>29</sup> A clearing house may be organized as a division of an exchange (TIFFE and CME are examples), may be affiliated with but separately incorporated from the exchange for which it clears trades (CBOT and the Board of Trade Clearing Corporation, which clears trades for the CBOT, is an example), or may have contractual and other obligations to clear trades for an exchange but no other legal affiliation with that exchange (the relationship between LCH and various U.K. exchanges prior to the reorganization of LCH on October 9, 1996 is an example). See *infra* note 36.

<sup>30</sup> Generally, clearing organizations collect "original" and "variation" margin payments from their clearing members. "Initial" and "maintenance" margins are required by brokers from their customers. Original margin is an initial performance bond required to be deposited by the clearing firm that has presented a futures contract for clearance.

In addition to making daily original margin computations, the clearing organization calculates variation margin requirements, representing daily profits or losses on the futures contracts carried by the clearing firm. Based upon these daily mark-to-market computations, the clearing organizations issue variation margin calls or makes variation payments, which are also referred to as daily "pays" and "collects" to its clearing members. Competitiveness Study, *supra* note 2, at 37 n.25. See also Collated Summary, *supra* note 2, at 124-148.

ner of its computation and what constitutes good capital for calculation purposes. Many of these differences have material consequences for the cost of doing business.

In computing capital requirements,<sup>31</sup> most jurisdictions' requirements are based on a measure of increased or decreased liabilities or volume of business and have a base threshold requirement below which capital may not fall. In the United States, capital increases with increased amounts of customer funds held by the firm. In the United Kingdom, that reference point is the higher of a percentage of the previous year's expenditure or initial margin (a lower amount under any definition than customer funds). In some jurisdictions, generally those with universal banking systems<sup>32</sup> like Germany and France, the thresholds are set so high that the requirements are fixed at such thresholds.<sup>33</sup> One jurisdiction, Japan, starts with a very high threshold level and increases the requirement on risk-based and concentration considerations.<sup>34</sup>

In general, acceptable regulatory capital in all jurisdictions for brokers is comprised of current or liquid assets.<sup>35</sup> Letters of credit

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<sup>31</sup> "Adjusted net capital" is a measure of liquidity and equals "net capital" (current assets minus liabilities) minus various charges or adjustments.

<sup>32</sup> In such jurisdictions, banks are permitted to engage directly (rather than through subsidiaries or bank holding company affiliates) in a broad range of financial services activities, including brokerage activities.

<sup>33</sup> The Capital Adequacy Directive of the European Community (CAD), however, has a fixed capital requirement of US\$ 203,000 and does not increase or decrease based on volume of business or risk undertaken. Competitiveness Study, *supra* note 2, at 50 n.41. The CAD establishes minimum standards, and most EC members require much higher levels of capital. Directive on the Capital Adequacy of Investment Firms and Credit Institutions, Council Directive 90/141 of 23 May 1990; Council Directive 92/13 of 27 January 1992.

<sup>34</sup> "[T]he base minimum net capital requirement for a U.S. futures commission merchant (FCM) which carries customer accounts and the U.S. dollar equivalent for similar firms doing business in the following foreign jurisdictions" are:

Jurisdiction (Minimum Required Capital)

1. United States (\$250,000)
2. Singapore (\$150,000)
3. United Kingdom (\$155,000)
4. European Community (\$203,000)
5. Germany (\$168 million for general clearing member; \$16.8 million for direct clearing member; only credit institutions within the meaning of § 1 of the banking act can be clearing members)
6. Japan (\$2.77 million)
7. France (\$147,375,000 for general clearing member of Matif; \$39,300,000 for individual clearing member of Matif; \$1,492,500 for all other brokers)

See Competitiveness Study, *supra* note 2, at 50 n.41; Collated Summary, *supra* note 2, at 93-102. U.S. dollar equivalents calculated on Aug. 22, 1996 (WALL ST. J., Aug. 22, 1996, at B4).

<sup>35</sup> The value of the asset which may be included in the capital computation varies from jurisdiction to jurisdiction. For example, U.S. capital rules require that FCMs and broker-dealers subject to regulation by the U.S. Securities and Exchange Commission (SEC) apply a 30% haircut (a percentage discount applied to the current market value of the security based on risk

may not be counted as capital, although in certain jurisdictions, bank guarantees can be treated as good capital. Subject to certain conditions, most jurisdictions permit subordinated loans<sup>36</sup> to be considered as good capital. In some jurisdictions there is an additional charge for concentrated positions related to a percentage of capital.

## *2. Clearance and Settlement*

As clearing houses maintain a perfectly matched book and therefore should be insulated from market risk, counterparty risk is not usually considered a significant risk element of exchange traded futures. Nonetheless, Barings most recently demonstrated that clearing houses remain exposed to the counterparty risk of their clearing members and, similarly, clearing members and their customers are still exposed to counterparty and settlement risks. Specifically, Barings also revealed that the manner in which the clearing guarantee operates varies widely, heightening trader's awareness that in some cases the clearing guarantee may not be a guarantee at all.

If the margin or performance bond posted by a member is insufficient to cover the member's losses, clearing houses use various means to ensure performance on the contract. In the United States, most clearing houses have guaranty funds consisting of member contributions, and in the event the member's contribution or the entire guaranty fund is inadequate, most exchanges have the ability to assess members to make up the shortfall. In the United Kingdom, the newly re-organized member and exchange-owned London Clearing House similarly has a Member Default Fund, supplemented by private default insurance coverage but has no automatic ability to make further assessments on members.<sup>37</sup> In France, the ultimate guaranty is pro-

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factors) to equities or if they elect the alternative treatment, a 15% haircut. Under the alternative treatment, the firm must meet a higher base minimum net capital requirement to qualify for the 15%. The base haircut in Japan is 30%. See Collated Summary, *supra* note 2, at 100-101.

<sup>36</sup> A subordinated loan agreement involves a lender providing a broker with cash, or with a secured demand note collateralized by the lender's pledge of securities or cash. See generally Commodity Futures Trading Commission, Form 1-FR-FCM Instructions 5-7 (July 1989). In order for the firm to be able to count the subordinated loan as good capital, it must satisfy the rules governing what constitutes a proper subordination agreement in effect in the relevant jurisdiction.

<sup>37</sup> Prior to its reorganization on October 9, 1996, the LCH which clears for LIFFE, LME and the International Petroleum Exchange in the United Kingdom, was owned by six shareholder banks who provided the clearing guaranty: Barclays, Lloyds, Midland, National Westminster, Royal Bank of Scotland, and Standard Chartered. Placing Memorandum: Proposals for Changes in the Ownership, Capital Structure and Financial Backing Arrangements Involving a Private Placing for The London Clearing House Limited (N.M. Rothschild & Sons Ltd.), July 1996, at 2.

vided by the Banque de France. Currently, none of the European futures clearing houses have express assessment powers.<sup>38</sup>

Although most jurisdictions mark exchange positions to market daily, not all clearing houses settle the gains and losses on a daily basis. At least one exchange, the LME, does not collect initial or maintenance margin or transfer gains or losses until the positions are closed out on the prompt (*i.e.*, final settlement) date. In Japan, although variation gains are credited to the account and losses are collected, the profits may not be withdrawn (although a percentage may be used to margin new positions) until the position is closed out.

### 3. *Margin and Credit Extension*

Performance bond (margin) requirements generally are set by the relevant exchange and, in many jurisdictions, are subject to some form of regulatory oversight. Clearing houses' margin calculation systems fall into one of two categories: (1) risk-based margin systems, such as "SPAN" (used by certain futures exchanges in the United States, United Kingdom, Japan, and Singapore) or "TIMS" (used by certain exchanges in Canada, Germany, Hong Kong, Netherlands and the United States);<sup>39</sup> and (2) margining based on a fixed percentage of contract values, used by many markets in the Pacific Rim.<sup>40</sup> The definition of good collateral varies among jurisdictions. Practice among clearing houses or exchanges varies as to whether letters of credit, equity securities or guarantees are acceptable as margin. A financial intermediary may accept different types of collateral from that accepted by the relevant clearing house or exchange and may also require higher levels of margin from its customers.

Although variation margin ordinarily is collected on a net basis, exchanges/clearing houses vary in whether they collect original margin on a gross or net basis. Under a net clearing system, original margin is posted by clearing firms based upon the net positions in their ac-

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<sup>38</sup> MOODYS GLOBAL CREDIT RESEARCH GROUP, CREDIT RISKS OF CLEARING HOUSES AT FUTURES AND OPTIONS EXCHANGES 230 (June 1995).

<sup>39</sup> *Id.* at 226. Standard Portfolio Analysis of Risk (SPAN) and Theoretical Intermarket Margins Systems (TIMS) are risk-based margin systems. SPAN, for example, margins option and futures positions in the same account on a portfolio basis, measuring the aggregate risk of the combined positions. The key element of SPAN is the "scanning risk charge" which is determined by calculating what a portfolio's gain or loss in value would be as a result of various changes in the underlying futures price, rate of volatility, and time to option expiration. This charge is set equal to the greatest potential loss resulting from these calculations. Memorandum regarding the Chicago Mercantile Exchange Proposed Dollars at Risk Option Margin System (Nov. 1988)(on file with the Commodity Futures Trading Commission).

<sup>40</sup> *Id.*



counts, reflecting an offset of long and short positions in the same futures contract. In a gross margining system, the offsetting long and short positions are each margined separately.<sup>41</sup>

#### *4. Protection of Customer Assets and Insolvency*

All jurisdictions require that intermediary firms maintain records distinguishing their funds from those of their customers, and most jurisdictions have some requirements relating to protection of customers' assets ranging from insurance or contingency funds, to the physical segregation of customer funds from those of the firm. In jurisdictions with a segregation requirement, the calculation of what must be segregated and for whom differs from jurisdiction to jurisdiction. In some cases segregation may be required of brokers but not of the ultimate custodian, the exchange/clearing house.

In universal banking jurisdictions such as Germany, Japan and the United Kingdom, the concept of segregation with respect to cash held by a bank/broker dealer may be inapplicable under relevant bank insolvency rules, all customers of the bank (irrespective of their status as a bank or brokerage customer) will claim their pro-rata share of the remaining assets of the bank. However, specifically identifiable assets of the customer held by the failed bank/broker in trust will be returned to that customer.<sup>42</sup> France is unique among universal bank jurisdictions in providing a Banque de France guarantee for all obligations of clearing members to their customers for transactions on organized French exchanges. Most jurisdictions also have requirements governing the location of customer funds and the manner of their investment.

These protections are intended to guard against the misappropriation of funds, to facilitate the transfer of positions following a firm's

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<sup>41</sup> Whether a net or gross margining system is used varies across jurisdictions and even within different markets in the same jurisdiction (France and the United States are examples, in this regard). If segregation is required by the exchange/clearing house, offsetting between the clearing member's customers' account and its house account is not permitted, even in a net margining system.

<sup>42</sup> See, e.g., *FIA Global Task Force Survey on Exchanges and Clearing Houses Responses on Financial Integrity Issues* (1995)(on file with author). The FIA Global Task Force on Financial Integrity was formed in response to industry concerns relevant to the Barings failure. It consisted of industry representatives from 17 jurisdictions. The FIA is a U.S.-based international association which acts as a principal spokesman for the futures and options industry. It ceased operation in June 1996.

Under the CEA, CFTC rule 190.10(c), 17 C.F.R. § 190.10(c), requires express disclosure to customers that non-cash margin deposited as collateral will receive no more protection than cash in the event of an FCM's insolvency.

financial crisis and to accord special treatment to customer funds when the financial intermediary becomes insolvent. The absence of segregation between firm and customer assets at the firm and clearing house levels can complicate and delay the transfer of non-defaulting customers' positions and other assets to solvent firms in the event of a firm default.<sup>43</sup> A firm may default when it has inadequate resources to satisfy its obligations to the clearing house. If such a firm was trading both for its own account and on behalf of customers, and assets had been commingled at the exchange/clearing house level, customers' funds might be used to finance proprietary positions of the firm (as occurred in Barings).

Although it is unlikely the Barings experience will result in the universal implementation of segregation, it has made regulators and market operators aware of the need to develop transparent policies relative to default procedures and to inform market users of the financial protection in place.<sup>44</sup> The other concern noted after the Barings experience was the need for certainty that each jurisdictions' insolvency laws would support the enforceability of such arrangements.

#### D. Customer Protection / Fairness Regime

All regulatory systems impose rules and regulations intended to ensure fairness and to detect and deter violative conduct by those doing business with the trading public. In general, these internationally accepted "conduct of business" principles can be summarized as requiring firms to: (1) act with honesty and fairness in conducting their business activities; (2) act with due skill, care and diligence; (3) have and employ effectively the resources and procedures needed for the proper performance of business activities; (4) seek from their customers information about their financial situation, investment experience and investment objectives; (5) provide adequate disclosure of relevant material information to customers; (6) avoid conflicts of interest and, when they cannot be avoided, to ensure customers are treated fairly; and (7) comply with all regulatory requirements applicable to the conduct of their business activities so as to promote the best interests of customers and the integrity of the market.<sup>45</sup> As discussed above, however, significant differences exist among jurisdictions in the

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<sup>43</sup> COMMODITY FUTURES TRADING COMMISSION, DISCUSSION PAPER ON DEFAULT PROCEDURES (May 1995).

<sup>44</sup> See note 66, *infra*.

<sup>45</sup> See IOSCO TECHNICAL COMMITTEE, REPORT ON INTERNATIONAL CONDUCT OF BUSINESS RULES 8-9 (July 1990).

scope and implementation of these rules and whether the rules apply to all or only certain customers.

### *1. Fitness and Qualification Standards for Authorization*

Most jurisdictions have fitness requirements for financial intermediaries, which consider previous violative conduct, character and competency. Jurisdictions vary, however in whether they require registration/authorization, perform fitness screening and test the trading and regulatory knowledge of individual salespersons. Also, the scope of the screening process with respect to firms and their principals vary significantly. Only a few jurisdictions take affirmative steps to confirm the accuracy of the information provided by applicants by cooperating with police authorities such as Interpol and foreign regulatory authorities to obtain fitness information on applicants.

### *2. Sales Practices and Disclosure*

In addition to prohibiting misrepresentation and other fraudulent conduct, nearly all jurisdictions have rules intended to ensure appropriate generic disclosures are made to customers about the risk of trading in futures prior to such investing and further require that customers acknowledge receipt of such disclosures.<sup>46</sup> As noted above, however, in some jurisdictions, these and other conduct of business rules may not be applicable to sophisticated, informed investors.

### *3. Priority of Order Execution*

Although most jurisdictions do not prohibit dual capacity trading (i.e., the ability of industry professionals to trade for their own account and for customer accounts simultaneously), a "customer first" rule generally is imposed when dual-capacity trading is permitted.

### *4. Recordkeeping and Reporting*

Generally, jurisdictions require the creation and maintenance of records, such as confirmations, with respect to the execution and financial effect of exchange transactions. Jurisdictions differ as to the

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<sup>46</sup> In view of the similarity of many jurisdiction's required disclosure text, several international regulators, including the CFTC, developed an agreed generic risk disclosure statement intended to satisfy the risk disclosure requirements of multiple jurisdictions. To date, only the CFTC, U.K. Securities and Futures Authority and the Central Bank of Ireland have adopted the generic statement. See Risk Disclosure by Futures Commission Merchants, Introducing Brokers, Commodity Pool Operators and Commodity Trading Advisors to Customers, 59 Fed. Reg. 38,118 (1994).

extent of the records and information which must be maintained or made available to customers.

#### E. Compliance Monitoring Programs

Jurisdictions also differ in the structure of their regulatory oversight programs, which have a significant impact on the scope and depth of their compliance monitoring programs. In many jurisdictions, market and customer protection responsibilities are vested in Ministerial level agencies which have a broad range of macroeconomic responsibilities (such as revenue collection and for setting tax and budget policies) and few resources for day-to-day financial services regulatory activities. Other jurisdictions have specialized governmental agencies which oversee self-regulatory organizations with statutory obligations to police themselves and their members.

#### F. Observations

Regulators internationally may agree that customer protection and market and financial integrity are the common objectives of regulation. However, as the discussion above illustrates, they have very different views on how best to achieve these objectives. Fundamental differences exist among jurisdictions as to what they regulate, who they regulate and how they regulate. These differences are manifested in the scope and content of jurisdictions' rules as well as in the scope and depth of their compliance monitoring programs. Although some of the areas of differences are superficial, many are not and reflect the unique characteristics of each jurisdiction's legal, cultural and business/market conditions.

For example, a statutory framework such as the United Kingdom's, which has as its focus the protection of the retail customer, may elect, as a matter of policy, that the full scope of its conduct of business rules need not apply to sophisticated institutional customers. In other systems, customers, irrespective of their sophistication, will not be permitted to opt out of the regulatory protections which the regulatory authority has deemed to be vital.

### III. TOWARDS REGULATORY CONVERGENCE

Market and regulatory trends appear to indicate that market authorities recognize that the consequences of a major regulatory failure may be too costly to risk endorsing approaches which are not anchored in certain internationally agreed principles, standards and

practices. This section describes some significant trends in the evolution of approaches to the regulation of global markets:

- episodes of market failure leading to reform;
- international regulatory coordination, both bilateral and multilateral; and
- market and other innovations, such as international market linkages leading to arrangements for the allocation of supervisory responsibilities.

These trends illustrate the event driven nature of regulatory change and reform. Indeed, the shared experiences of similar or identical “disasters,” the need to reach common understandings of risks posed by innovations such as market linkages and the development by IOSCO of international consensus on issues of common regulatory concern explain why regulatory diversity is evolving within the framework of agreed “rules of the game.” They also provide support for the view that existing regulatory regimes are converging towards internationally accepted standards of regulation.

#### A. Episodes of Market Failure Leading to Reform

Market or firm failures can result in loss of confidence in a marketplace, and the regulatory and self-regulatory responses to such failures are an indication of the importance exchanges and regulators attach to maintaining or restoring a reputation for financial integrity. As demonstrated by recent incidents involving Barings and Sumitomo, episodes of market or firm failure inevitably lead to regulatory action.<sup>47</sup>

##### 1. *Barings Failure*

The failure of Barings, a British merchant bank, was caused by a cumulative loss of over £827 million on substantial proprietary positions entered into by a Barings trader based in Singapore on various international futures markets.<sup>48</sup> In May 1995 representatives of regulatory authorities in 16 countries responsible for supervising the activities of the world’s major futures and options markets were invited by the CFTC and SIB to discuss key issues resulting from the failure of

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<sup>47</sup> See generally Competitiveness Study, *supra* note 2, which also discusses the regulatory responses following the 1985 tin crisis on the LME, the near default of the Hong Kong Futures Exchange following the market crash of October 1987, the events leading to the issuance of the U.K. Large Report and events addressed by the U.S. Futures Trading Practices Act of 1992 amending the CEA.

<sup>48</sup> See BOARD OF BANKING SUPERVISION, BANK OF ENGLAND, INVESTIGATION INTO THE FAILURE OF BARINGS 232 (1995).

Barings.<sup>49</sup> In the ensuing Windsor Declaration, the authorities agreed to a program of work to ensure that regulatory concerns in four areas revealed by this failure were addressed:

- cooperation between market authorities,
- protection of customer positions, funds and assets,
- default procedures, and
- regulatory cooperation in emergencies.<sup>50</sup>

The Windsor Declaration contemplated work to be carried forward both by the individual authorities who attended the meeting and also on a broader multilateral basis through appropriate international bodies, such as IOSCO.<sup>51</sup>

At the same time, the industry initiated an ambitious program of work by markets, market members and market users. Separately, a number of individual market authorities initiated their own regulatory and procedural reviews in light of the Barings collapse.<sup>52</sup> All of the separate initiatives essentially reflect certain fundamental lessons reinforced by the Barings failure, and include:

- first, better mechanisms for sharing information related to large exposures and for communication during emergencies among regulators and market authorities were critically needed in order to reduce the potential for disruptive market events and to manage such events and their consequences appropriately should they materialize,
- second, that market users did not have adequate knowledge of the scope and nature of existing market protection and procedures, in particular as to the treatment accorded their positions, funds and assets in a worst case scenario, and that enhanced transparency could assist them to act appropriately during a disruptive event, and
- third, the need for market authorities to agree and implement standards of best practice related to market default procedures and the treatment of customer positions, funds and assets by markets and financial intermediaries.<sup>53</sup>

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<sup>49</sup> See Windsor Declaration, May 1995 (on file with author). The meeting in Windsor was chaired by the CFTC and SIB. Other participants included futures regulatory authorities from: Australia, Brazil, Canada, France, Germany, Hong Kong, Italy, Japan, Netherlands, Singapore, South Africa, Spain, Sweden, and Switzerland.

<sup>50</sup> *Id.*

<sup>51</sup> In July 1995, following the Windsor meeting, the Presidents Committee of IOSCO adopted a resolution supporting further work by the IOSCO Technical Committee on post Windsor issues.

<sup>52</sup> This work was carried out by the FIA Global Task Force on Financial Integrity.

<sup>53</sup> See Final Report from the Co-Chairmen of the May 1995 Windsor Meeting to the Technical Committee of IOSCO (August 1996) [hereinafter Windsor Report]. The report was disseminated during the XVII annual meeting of IOSCO in Montreal, Canada with the following additional reports:

The Final Report further identifies the following fundamental changes which have been achieved:

- large exposure companion information sharing arrangements at the regulator and market level, which are unique in that they are trigger-based and permit an integrated multilateral assessment of market risk,<sup>54</sup>
- the development of procedures to better coordinate and respond to a market crisis once it has materialized,<sup>55</sup>
- initiatives to increase the transparency of market protection and procedures, including proposals for the strengthening of client asset protection,
- initiatives intended to encourage the development of “best practices” concerning market default procedures and the treatment of positions, funds, and assets to contain systemic risks; and
- reviews by regulatory authorities of the situation in their domestic jurisdictions, leading to change in some cases.

These initiatives represented an unprecedented level of cooperation between regulatory and market authorities to enhance market and customer protection and minimize systemic risk.

## *2. Sumitomo Corporation*

The events surrounding extreme volatility in the copper market and the over \$2 billion in copper trading losses sustained by Sumitomo Corporation have resulted in the issuance by the SIB of a Consultative Document on the LME seeking public views on a number of trading practices and market regulations covering transactions in metal both on the LME and over-the-counter.<sup>56</sup> The SIB document seeks re-

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- a compendium, prepared from reports by individual jurisdictions represented at Windsor, on domestic work undertaken in the last year to implement Windsor recommendations;
  - a summary by the IOSCO Secretary General of the IOSCO work, carried forward since the last report in July 1995, to fulfil the remit from the Declaration which IOSCO agreed at Windsor to complete; and
  - a paper by the FIA Global Task Force on post-Barings initiatives that have been completed in that group.

<sup>54</sup> See IOSCO, DECLARATION ON COOPERATION AND SUPERVISION OF INTERNATIONAL FUTURES EXCHANGES AND CLEARING ORGANIZATIONS (1996) [hereinafter Declaration]. The declaration is an initiative of the Windsor Co-Chair and which was signed by 14– now 15– jurisdictions at Boca Raton in Florida in March of 1996, and a companion Memorandum of Understanding and Agreement which 49– now 54– international futures exchanges and clearing organizations signed under the auspices of the FIA Global Task Force.

<sup>55</sup> See IOSCO TECHNICAL COMMITTEE, COOPERATION BETWEEN MARKET AUTHORITIES AND DEFAULT PROCEDURES (1996).

<sup>56</sup> See LME Review, *supra* note 6. The actions of Sumitomo relevant to volatility in the copper markets in late 1995 also are the subject of a cooperative investigative inquiry by the CFTC and SIB. See COMMODITY FUTURES TRADING COMMISSION, News Release No. 3918-96, CFTC STATEMENT CONCERNING THE COPPER MARKET (June 14, 1996); See also Sumitomo Cor-

sponses on a number of detailed and technical issues with the aim of ensuring that the regulation of the LME strikes an appropriate balance between competing issues, such as transparency and liquidity and the needs of commercial users and other traders. The Sumitomo announcement also demonstrated that trading in physical delivery commodity markets can raise special market integrity and surveillance concerns and may need to be the subject of further examination by regulators of such markets. To that end, the CFTC, SIB and the Japanese Ministry of International Trade and Industry co-sponsored an international conference on November 25-26, 1996, to examine the special market surveillance, contract specification and information sharing issues raised by such markets.

In addition, market events such as Sumitomo and Barings can raise questions relative to the efficient operation of existing mechanisms to share information to address the effects of such events. The CFTC and SIB therefore proposed, and IOSCO has approved a new work mandate to particularize, for each type of market event, the types of information which market and regulatory authorities may need to share.

#### B. Market and Other Innovations

Another important trend is the competition among markets for market share. This presents its own challenges for regulators. Markets have been innovative in their attempts to provide around-the-clock access to their products whether via:

- international arrangements for the clearance of trades, either mutually, as in the case of the CME/SIMEX mutual offset system, or unitary, where one exchange clears for the contracts of both linked exchanges,
- dispersed screens, as in the case of the CME's GLOBEX trading system,
- dispersed trading floors, as in the case of the New York Cotton Exchange's FINEX division's operating floor in Dublin, Ireland,
- electronic linkage arrangements with foreign exchanges, as in the case of GLOBEX with Matif and NYMEX ACCESS with SYCOM, which provides for cross-exchange access by the members of one exchange to the products traded on the other, without having to become members of the other exchange, or
- the linking of two exchanges' floor trading systems, that is, cross-exchange access not of two exchange's products trading side-by-side on

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poration Press Statement (Sept. 19, 1996) (revising initial estimated loss of 1.8 billion to 2.6 billion dollars).



the same electronic trading system but of two exchanges' trading floors on a cross border basis, as is contemplated in the proposed link between the CBOT and LIFFE.<sup>57</sup>

Innovations by markets<sup>58</sup> also result in the development by intermediaries of innovative means of delivering services, which also challenge the traditional approach to customer protection and the application of conduct of business rules. In mature regulatory systems, the statutes and rules generally did not contemplate dispersed 24-hour markets. As a result traditional concerns regarding the need for registration and firm sponsorship of employees who engage in regulated conduct frequently need to be reinterpreted to facilitate order flow and to address access issues.<sup>59</sup>

These market and firm innovations have the effect of enhancing regulatory cooperation and coordination in that no regulator alone will have the resources or capabilities to monitor all aspects of the activities which may be subject to its requirements. In addition, common sense means that most linkage arrangements must be supported by uniform or at least similar rules at cooperating exchanges.<sup>60</sup> These developments have caused the relevant regulators to identify the areas of common concern and to allocate their supervisory responsibilities efficiently to address both areas of regulatory gaps and duplication.

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<sup>57</sup> The initial filing was made in July 1995, and review of the project by Commission staff is on hold at the request of the two exchanges.

<sup>58</sup> By last count, there were eight linkage arrangements involving floor and electronic systems. See Laurie Morse, *Strategic Alliances*, FUT. IND. 10, 11 (May 1995).

<sup>59</sup> See CFTC Interpretative Letter 92-11, [1990-1992 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶25,325 (June 25, 1992), and superseded in part by CFTC Interpretative Letter 93-83, [1992-1994 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶25,849 (Aug. 9, 1993), addressing the ability of members of the CME to pass the book of their customers' orders to their foreign affiliates (who are not CFTC registered) with access to GLOBEX terminals to accept and enter orders for CME contracts during hours when GLOBEX is operational; and CFTC Interpretative Letter No. 93-1115, 2 Comm. Fut. L. Rep. (CCH) ¶25,932 (Dec. 23, 1993), facilitating order flow relative to FCM's customers omnibus accounts carried by affiliated foreign brokers for execution of foreign trades.

<sup>60</sup> For example, CME Rule 575 implemented the MATIF/CME cross-exchange access proposal. Rule 575.A. establishes the general requirements pursuant to which members of another exchange participating in a cross-exchange access program with the CME could become eligible to trade through GLOBEX in certain CME-listed contracts without becoming members of the CME. Rule 575.B. establishes requirements by which CME members could trade through GLOBEX in the contracts listed by another exchange participating in a cross-exchange access program with the CME. In essence, the CME would adopt the trading rules of the foreign exchange so that its members could access the contracts of the other exchange and vice versa and each exchange would agree to monitor its members for compliance with the other exchange's trading rules.

## B. International Regulatory Coordination

### 1. *Coordination Efforts*

In a global marketplace, no one regulator will have access to all the information or powers it needs to carry out its regulatory and enforcement powers. Even if it had the powers, it likely will not have the resources to exercise them. Therefore, regulators increasingly cooperate internationally on a bilateral and multilateral basis for a broad range of purposes:

- investigatory and law enforcement purposes;
- to enhance the supervisory capacities of regulators charged with monitoring the activities of onshore firms and markets which may be impacted by the activities of related offshore firms and markets, for example, financial information sharing memoranda which provide for the sharing of risk assessment information;
- to promote the efficient allocation of regulatory responsibilities when one regulator has agreed to defer to the regulatory oversight activities of another regulator whether in the context of linkage arrangements between two markets or when registration and other rules are sufficiently comparable to permit reliance on the other system; and
- to promote technical and other assistance in the development of a financial infrastructure to support a market and other financial services activities.

Judging by the number of arrangements which exist today, the importance of such cooperative arrangements between relevant regulators appears to be universally accepted.<sup>61</sup>

### 2. *IOSCO and BASLE*

IOSCO's primary objective is to develop, on a global basis, high standards of financial market regulation, minimize systemic risk and facilitate cross border transactions. The main focus of its work is in the following areas:

- promoting arrangements to improve cooperation and communication flows between regulatory authorities,
- promoting the development of effective supervisory arrangements for securities and derivatives firms and in particular for internationally active and diversified financial groups,
- promoting measures to enhance the transparency, integrity and robustness of financial markets and market processes, and

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<sup>61</sup> See IOSCO, INDEX OF MEMORANDA OF UNDERSTANDING AND SIMILAR AGREEMENTS BETWEEN IOSCO MEMBERS (July 1996). The index documents approximately 465 agreements in effect in 52 jurisdictions.

- contributing to the fight against financial fraud and ensuring that the regulatory system responds in a timely and effective manner to new regulatory challenges.<sup>62</sup>

Increasingly, IOSCO has been coordinating its efforts with BASLE,<sup>63</sup> and both organizations have resolved to work together actively to promote the common goal of “improving the quality of supervision worldwide and responding to financial market developments in a timely, effective and efficient manner.”<sup>64</sup> In carrying out joint initiatives in areas such as internal controls and management, capital adequacy, financial conglomerates and market emergencies, the two groups have taken particular note of the evolving marketplace, the risks associated with new trends in global trading and the need to develop effective arrangements for supervising diversified financial groups operating internationally.<sup>65</sup>

#### D. Observations

The discussion of market and regulatory developments illustrates the event-driven nature of regulation. “Disasters” consistently show that regulatory/market failures result in a loss of confidence in a marketplace. Regulators and market operators alike recognize that the failure to implement prompt, effective measures to address a failure can adversely affect the ability of their markets to weather the crisis and continue to attract international business. Thus, market disasters consistently have had the effect of prompting regulators to take measures to enhance existing protection. These events also have had the collateral benefit of prompting similar enhancements by regulatory authorities generally.

In addressing innovations by their internationally active markets and firms to attract volume and customers in a 24-hour market environment, affected regulatory authorities must achieve a common understanding of the risks raised by such proposals. These common understandings of risk facilitate negotiations to allocate regulatory

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<sup>62</sup> See generally BASLE/IOSCO, RESPONSE OF THE BASLE COMMITTEE ON BANKING SUPERVISION (BASLE) AND OF THE INTERNATIONAL ORGANIZATION OF SECURITIES COMMISSIONS TO THE REQUEST OF THE G7 HEADS OF GOVERNMENT AT THE JUNE 1995 HALIFAX SUMMIT (May 1995) [hereinafter Joint Statement]; IOSCO, RESPONDING TO THE CHALLENGE - SUPERVISING GLOBAL FINANCIAL MARKETS (May 1995).

<sup>63</sup> BASLE was established by the central bank Governors of the Group of Ten countries in 1975 and consists of senior representatives from banking supervisory authorities in Belgium, Canada, France, Germany, Italy, Japan, Luxembourg, Netherlands, Sweden, Switzerland, the United States, and United Kingdom.

<sup>64</sup> See Joint Statement, *supra* note 62.

<sup>65</sup> *Id.*

and/or SRO responsibilities to avoid regulatory gaps and to minimize regulatory duplication. Thus, innovations will lead to the development of consensus on new risk elements of market proposals, and the resulting supervisory arrangements may enhance existing regulatory protection.

Finally, the internationalization of the marketplace is also motivating individual regulators through multilateral forums such as IOSCO to establish minimum standards or develop consensus on a broad range of issues of concern to derivatives (and securities) regulators, including screen-based trading systems, internal controls, exchange default procedures and cross-border fraud. As market events increasingly, almost inevitably, have international implications and effects, regulators increasingly are aware that unilateral regulatory responses alone will not be adequate or appropriate.

Despite the best efforts of regulatory and market authorities, the one certainty is that no system of regulation can guarantee against failures. The fact that post-Barings, fifteen regulators and 54 futures exchanges signed up to a large exposure, information sharing arrangement signals the resolve in the financial community that they must be better prepared to address a similar event in the future.

Undoubtedly, newly established and evolving markets either have faced or will face events and crises similar to those already experienced by mature markets. They are in the unenviable position of being the latecomers to futures markets in a competitive global marketplace, and newly established regulators may come under great pressure to develop an entire regulatory structure to meet market start-up schedules. Although it is acknowledged and perhaps accepted that their rules and regulations will reflect the nascent and evolving nature of their markets, emerging markets would be prudent to put in place regulatory mechanisms which are familiar to the international financial community.

#### IV. ACHIEVING REGULATORY BALANCE: REGULATORY PRACTICE MAKES PERFECT THEORY

National policy makers and regulators of financial markets must understand that they cannot, through any means available to them, regulate risk out of the system or be prepared for all contingencies. The challenge they face, therefore, is to achieve a balance between prudent regulation and acceptable levels of risk. Internationally, regulators agree on the components of a balanced regulatory system—the system must have rules addressing market integrity and efficiency,

financial integrity and customer protection. Efforts by international organizations such as IOSCO give further content to these components by developing international consensus on issues of universal interest to regulators. Through this process, IOSCO plays a critical role in delineating minimum standards of acceptable conduct and ensuring that unchecked regulatory competition does not lead to a race to the bottom.

Beyond that, however, it is clear that the manner in which this balance is achieved varies from jurisdiction to jurisdiction. These differences may be explained in large part by some or all of the following factors:

- differences in history, culture and national customs and practices;
- legal or juridical distinctions among jurisdictions, for example, common law versus civil code;
- universal banking and non-universal banking or mixed jurisdictions;
- differences in level of market maturity;
- differences in objectives of statutory framework, that is, market integrity, customer protection, or both;
- differences in the role of markets, for example, public or private markets, and type of market and market participants, for example, physical delivery market with predominately commercial participation or market with significant retail participation;
- differences in market structure, for example, floor based or electronic.

Indeed, there are sharp philosophical differences in the scope of the rules of major market jurisdictions, the measures they rely on to achieve regulatory objectives and the weight they give to any particular measure.<sup>66</sup>

It would be naive to characterize any one system as better than another. Some systems, for example, clearly maximize regulatory protection, but at cost levels and with a level of prescriptiveness which would be unacceptable in many jurisdictions. In some jurisdictions, the creation of a supervisory body solely in response to a perceived political need "to have what everyone else has" may not materially alter the way in which markets operate or behave, not unreasonably leading one to conclude, as did Karl Marx in another context, if a

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<sup>66</sup> This does not mean that there are no areas of regulation which could benefit from harmonization. The generic risk disclosure statement initiative referred to above is one example of a technical, but significant aspect of futures regulation which lends itself to standardization and simpler, more meaningful disclosure to customers with lower compliance costs for firms. The difficulty of harmonizing requirements, however, is reflected in the fact that since its development in 1994, only three jurisdictions have adopted the statement, notwithstanding the fact that many jurisdictions participated in and endorsed the initiative and have statements which are virtually identical to the generic text.

regulator does not exist, the market will have to create one! If market volume is any indication, however, no one system is more conducive to market success than any other. For this reason, the wholesale importing of another jurisdiction's regulatory system is rare and most jurisdictions, in developing systems or initiating change, at best "benchmark" their systems to other systems, or review such systems to avoid pitfalls others have experienced.

Regulatory competition within the framework of internationally accepted parameters enhances regulatory innovation and diversity. By doing so, it provides a market mechanism which inhibits regulators from adopting rules that impose excessive costs in respect of their benefits.<sup>67</sup> It also creates choices for market participants, allowing them to select regulatory levels that are most suitable to their current circumstances and prevailing market conditions.<sup>68</sup> And, as noted above, it provides regulators the opportunity to engage in regulatory benchmarking, permitting them to incorporate the best features of other systems into their own systems which can lead to further regulatory evolution.

Last but not least, regulatory competition permits evolving market jurisdictions for whom harmonization may be particularly difficult to selectively implement rules and procedures most appropriate for their needs in light of their financial services goals, to, in effect, "free ride" on the experiences and/or misfortunes of other jurisdictions. It is this concept of "regulatory leapfrogging" which essentially has been endorsed by the G7 Ministers as means of minimizing systemic risk resulting from the development of new markets.<sup>69</sup>

### CONCLUSION

The appeal of standardization or harmonization of regulatory requirements is difficult to discern. Very different regulatory approaches have led to equally successful results, and no one system will work in all jurisdictions. The concern with regulatory competition is that if unchecked, it can confirm the worst fears of those who advocate regulatory harmonization—that it will lead to the lowest com-

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<sup>67</sup> Joseph A. Grundfest, *Internationalization of the World's Securities Markets: Economic Causes and Regulatory Consequences*, 4 J. FIN. SERV. RES. 349, 372. See also Alan Greenspan, *Testimony before the House Committee on Banking, Finance and Urban Affairs*, 101st Cong., 1st Sess., 30 (1990):

[I]n human affairs, whether it were in business, whether in government regulatory organizations, whether we're in any activity, competition is a very effective tool.

<sup>68</sup> *Id.*

<sup>69</sup> Lyon Communique, *supra* note 3, at 7.

mon denominator in regulation. Perhaps, for this reason the term "competition" used in the context of regulation is sometimes viewed as pejorative and inappropriate.

Regulatory diversity, however, can and should be encouraged. Market and business conditions change, and the regulations which prescribe standards of acceptable conduct must evolve with such changes. Innovations or new methods which achieve similar protection but in different and relatively less costly ways should be continuously examined and considered for implementation. In a competitive marketplace, regulators cannot afford to be either insular or parochial in the way they go about making public policy decisions regarding what constitutes prudent regulation and what are acceptable levels of risk. Regulatory diversity should not be endorsed, however, without a firm commitment by international regulators to cooperate to ensure that the agreed rules of the game, which too may need to evolve, are understood, accepted and observed.