MERCATUS CENTER
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REGULATORY STUDIES PROGRAM

Public Interest Comment on

The Securities and Exchange Commission's Rule Proposal for Registration of Broker-Dealers Pursuant to Section 15(b)(11) of the Security Exchange Act[1]

The Regulatory Studies Program (RSP) of the Mercatus Center at George Mason University is dedicated to advancing knowledge of the impact of regulation on society. As part of its mission, RSP conducts careful and independent analyses employing contemporary economic scholarship to assess rulemaking proposals from the perspective of the public interest. Thus, this comment on the Securities and Exchange Commission's *Registration of Broker-Dealers Pursuant to Section 15(b)(11) of the Securities Exchange Act* does not represent the views of any particular affected party or special interest group, but is designed to evaluate the effect of the Commission's proposals on overall consumer welfare.

The Commodity Futures Modernization Act of 2000 (CFMA) amended the Commodity Exchange Act (CEA) to allow trading of futures contracts on individual equity securities and narrow-based indices of equity securities subject to joint regulation by the Commodity Futures Exchange Commission (CFTC) and the Securities and Exchange Commission (SEC).[2] Section 203, "Regulatory Relief for Intermediaries Trading Security Futures Products" provides for an expedited registration procedure that allows broker-dealers in the securities industry who are registered with the SEC to obtain notice registration to trade security futures products from the CFTC (via the National Futures Association). Similarly, Section 203 prescribes that brokers and dealers in the futures industry, including futures commission merchants and introducing brokers, can obtain notice registration with the SEC in order to trade these products. The CFMA is clear in its purpose to set up a mechanism by which registered intermediaries in either the futures or the securities markets can expeditiously attain the status of dual registrant with both the

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[2] "The Commodity Futures Modernization Act of 2000," Public Law No. 106-554. The bill, H.R. 5660, is available at http://agriculture.house.gov/txt5660.pdf.

securities (the SEC) and the futures (the CFTC) regulators in order to avoid duplicative registration and reporting processes required of the respective regulators.

Despite the intent of the CFMA to expedite the registration process, the SEC has proposed a registration format that would result in time-consuming duplication of registration procedures for futures commission merchants and introducing brokers already duly registered with the CFTC.[3] In addition, the proposed procedure denies these futures intermediaries the ability to obtain notice registration if their intention is to trade security futures products on a registered national securities exchange. Unlike a recent CFTC rule proposal that enables notice registration for broker-dealers in the securities industry and provides exemptive relief from duplicative requirements regardless of where the products are traded, the SEC proposes that futures registrants who intend to trade security futures products should register as full broker-dealers with the SEC subject to all the costs and regulations thereof, or otherwise effect and clear their transactions through a full broker-dealer registered on the securities exchange.[4]

The SEC proposal sets aside the purpose of the CFMA by advancing a legalistic interpretation that results in different standards for futures registrants than those required for securities registrants. By subjecting futures intermediaries to redundant and burdensome registration requirements, the proposal will increase their costs, those of their customers, and the public.

I. Background

Title II of the CFMA, "Coordinated Regulation of Security Futures Products," lifts the prohibition on the trading of single-stock futures that has been in effect since the Shad-Johnson Accord of 1982. Attempting to resolve ongoing jurisdictional disputes between the SEC and the CFTC, the Shad-Johnson Accord was an agreement between the then chairmen of the two regulatory commissions (John Shad and Philip Johnson, respectively) to minimize overlapping regulatory authority between them in derivatives, including specifically futures and options on equity securities. In the Accord, while the CFTC became the exclusive authority over futures on stock indices, the SEC became the exclusive regulator of options on securities and options on stock indexes.[5] After nearly 20 years, the CFMA resolves the jurisdiction question with respect to single stock futures legislatively, by detailing the terms of joint jurisdiction that provide regulatory certainty for these products regardless of the market in which they are traded.

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[3] See *Federal Register* Release 17 CFR Parts 240, 248, and 249, No. 34-44455, Vol. 66, No. 123, pp. 34042 – 34081, June 26, 2001, available at http://www.access.gpo.gov/su_docs/fedreg/a010626c.html.

[4] See *Federal Register* Release 17 CFR Parts 3 and 170, Vol. 66, No.96, 27476-27480, May 17, 2001, available at http://www.cftc.gov/files/foia/fedreg01/foi010517a.pdf.

[5] For a discussion of the costs this regulatory turf battle has entailed, see Kenneth Lehn, "Observations on the Shad-Johnson Accord and SEC-CFTC Jurisdictional Disputes," in Charles Smithson, *Managing Financial Risk*, Third Ed., McGraw-Hill Companies, 1998, pp. 347-348.

The CFMA contains amendments to the Securities Exchange Act (SEA) and the Commodity Exchange Act (CEA), identifying single-stock futures and futures on narrow-based indices as futures contracts as defined by the CEA, but also subject to federal securities laws. For the purposes of regulation and operational oversight, the CFMA prescribes that these security futures products can only be traded by intermediaries and on trading facilities that are registered with both the CFTC and the SEC.[6] As a result, intermediaries and trading facilities that are presently registered with either the SEC or the CFTC who wish to trade security futures product may register with the other agency by filing a written notice that becomes effective immediately upon its submission.

In its *Federal Register* release, the SEC outlines the procedure for notice registration in proposed rules 15b11-1, 15b11-2, and 15a-10.

(1) Proposed Rule 15b11-1 requires that a futures intermediary seeking notice registration should file Form BD, the uniform application for securities broker-dealers, which requires the applicant provide detailed information regarding financial, legal, and corporate activities.

(2) Proposed Rule 15b11-2 prescribes that a notice registered broker-dealer seeking to conduct business in something other than security futures products must file an amended Form BD with the SEC. Once approved for full broker-dealer status, the SEC would become the "primary regulatory authority" with regard to the registrant's activities and be subject to all the provisions of the Securities Exchange Act.[7]

(3) Proposed Rule 15a-10 states that notice registration is not available to an introducing broker or an FCM unless it is a member of a "national securities exchange registered pursuant to Exchange Act section 6(a)."[8] The implies that futures registrants who are not members of a national securities exchange must either restrict their trading of security futures products to derivatives trading execution facilities or effect their transactions through a securities broker dealer.

(4) By implication of (2) and (3), the SEC proposals result in a requirement that futures intermediaries who seek to effect transactions in security futures products on a national securities exchange register as a full broker-dealer with the SEC and would then be subject to all the provisions of the Securities Exchange Act. Hence, futures registrants who wish to trade security futures contracts (and not other securities), but wish to do so on a registered national securities exchange would **not** be eligible for exemptions from regulations mandated explicitly by the CFMA.[9]

[6] *SEA* sections 6(g) and 15(b)(11); *CEA* sections 5f and 4f(a)(2).

[7] 66 *Fed. Reg.*, p. 34046.

[8] 66 *Fed. Reg.*, p. 34044.

[9] Exemptions detailed in 15 U.S.C. 78h, 78k, 78o(c)(3), 78o(c)(5), 78o-4, 78o-5, 78q(d)(i).

II. The SEC Interpretation of the CFMA

Proposed Rule 15b11-1 specifies that an intermediary currently registered with the CFTC, or CFTC registrant, must complete Form BD, the "Uniform Application for Broker-Dealer Registration," and file it with the Central Registration Depository (CRD). While the CFMA directs that the notice registration process should not duplicate the registration process already accomplished by the registrant, Form BD is both long (24 pages), complex, and obviously duplicative of Form 7-R, the form required to have been filed with the National Futures Association (NFA) (as delegated by the CFTC) as a condition for registration as an introducing broker or FCM. Since forms filed with the NFA are stored electronically, a detailed database containing registration information is available to the CRD. Consequently, much of the information that the SEC envisions as necessary or appropriate has already been collected as part of the futures registration process and is readily available to the SEC electronically and instantaneously.

A. Requiring Notice Registration on Form BD is Duplicative and Time-Consuming

If the purpose of notice registration is to expedite the process by which registrants to one regulatory authority may obtain dual registration status, then a shorter, more concise format than Form BD is appropriate. If the SEC deems that there is information necessary that is not collected by the NFA when it registers the futures intermediaries, then that information could be obtained at a much lower cost in time and effort. If Form BD only re-collects previously reported information, then requiring the completion of the entire form raises the costs of complying with federal regulation without any marginal benefit.

Perhaps more troubling from the perspective of regulatory fairness is the simpler approach taken by the CFTC in their proposal to register securities broker-dealers to trade security futures products. The SEC proposes that registered futures intermediaries complete the 24 page Form BD, which largely repeats information collected on the Form 7-R already filed by futures registrants. While the CFTC proposal delegates the registration authority to the NFA, indications are that the form will be 1 page in length and follow the guidance provided by the CFMA. Specifically, the form will verify that the registration is for the limited purpose of trading security futures products, that the broker-dealer's registration is not suspended, and that the broker dealer is a member of a national securities exchange.[10] Recollecting information that is already on file with the CRD is not required by the CFTC, and as such, it establishes no parallel requirements that notice registrants from the securities industry file CFTC/NFA Form 7-R required of introducing brokers and FCMs in the futures industry.

[10] 66 *Fed. Reg.* p. 27477, May 17, 2001.

B. Incongruous Regulatory Restrictions for Futures Registrants

In its interpretation of the CFMA and the amendments to the *SEA*, section 15(b)(11)(A), the SEC proposes that introducing brokers and FCMs cannot file for notice registration unless they are a member of a national securities exchange registered with the SEC according to section 6(a) of the *SEA*. Thus, in order to effect security futures transactions that are traded on a securities exchange, the release suggests that futures registrants should effect transactions in security futures through a full broker-dealer that is a member of a registered exchange. This provision implies that notice registration of futures intermediaries would only allow them to trade security futures products in futures markets (derivatives trading execution facilities). This determination by the SEC creates an incongruous regulatory structure that raises the costs of trading security futures products by directing futures intermediaries to employ an additional layer of intermediation in order to effect and clear transactions on national securities exchanges.

The SEC proposes explicitly that an introducing broker or FCM qualifies for notice registration as long as it is not (1) "a member of a national securities exchange pursuant to section 6(a) of the Act" and (2) "a member of a national securities association registered under section 15A(k) of the Act."[11]

While the CFMA is confusing in its language that sets aside the provision for notice registration in the event that the broker or dealer is not a member of a national securities association, the SEC's rationale for denying notice registration to trade security futures products on registered national securities exchanges is not consistent with the otherwise clear intent of the CFMA. While the SEC suggests that "the plain language of section 15(b)(11)(A) limits a Security Futures Product Broker-Dealer to effecting transactions in security futures products only on Security Futures Products Exchanges," a review of Section 203 does not provide the basis the SEC derives for the restriction on futures registrants. Instead, Section 203's prominent use of the terms "regulatory relief" and "expedited registration" suggests its purpose is to facilitate the trading of security futures products by encouraging regulatory cooperation between the CFTC and the SEC.[12] In general, with respect to the joint regulatory structure proposed, the CFMA grants the SEC and the CFTC with the authority and obligation to "avoid duplicative or conflicting regulations applicable to any broker or dealer."[13]

C. Implications for competitiveness

By preventing futures notice registrants from trading security futures on national securities exchanges until they attain the status of full broker dealers (requiring exchange membership and national securities association membership) the SEC has granted a competitive advantage to securities broker-dealers. Section 4a(f) of the *CEA* is interpreted

[11] 66 *Fed. Reg.*, p. 34045.

[12] *CFMA*, Section 203 (a), p. 155.

[13] *CFMA,* Section 206 (i-j), p. 187.

by the CFTC to allow notice registrants from the securities industry to trade security futures products on both designated contract markets and national securities exchanges. Thus, securities broker-dealers will have unrestricted access to all markets where security futures are traded.

In addition, the SEC's interpretation creates a competitive disadvantage for the national securities exchanges that are contemplating offering security futures products. The SEC ostensibly takes authority away from national securities exchanges to determine if a futures registrant should be granted membership and under what conditions. Exchanges in the securities and futures markets seek to create liquid and deep contract markets free from fraud and manipulation that would otherwise discourage their business. It is in their interest to establish standards for membership that attain these goals and the SEC has not demonstrated any systematic failure by the exchanges in this regard that would justify its usurpation.

While the SEC suggests its proposal satisfies the CFMA intention to "prevent competitive advantages from arising solely out of differences between futures regulation and securities regulation," its interpretation in fact creates competitive advantages for securities broker-dealers. The CFMA does not mandate, nor is its intent to mandate, incongruous treatment for registrants from the futures industry on the one hand, and registrants from securities industry on the other. Even a joint statement by the SEC and the CFTC suggests that the expedited registration afforded by section 203 applies with equal force to futures registrants by suggesting they satisfy the statutory definition for broker-dealers for purposes of trading security futures products.[14]

III. Conclusion

The SEC's proposed rules regarding registration of futures intermediaries who seek to trade security futures raise operational costs and create increased costs of compliance. These costs arise from the requirements that introducing brokers and FCMs that wish to trade security futures must:

(1) Collect and organize detailed information in order to complete a long and time consuming form that duplicates information already on file with the NFA;

(2) Go through another layer of intermediation to effect and clear transactions if traded on a national securities exchange, increasing transactions costs to complete a security futures transaction to intermediaries and investors; or

(3) Go through the time and expense of becoming a securities broker-dealer, even though the intent of the registrant may only be to trade security futures, not securities; and

[14] *Joint Statement*, 2001.

(4) Be subject to the full reporting and compliance costs of two regulatory authorities, the SEC and the CFTC, since becoming a full broker-dealer nullifies exemptions granted under the CFMA

Since these additional costs are incurred to satisfy regulatory requirements and standards for fitness that are already accomplished and monitored by futures regulatory authorities, self-regulatory authorities, and futures exchanges and industry associations, the SEC proposals create costs without producing any marginal benefit to investors or for the public interest at large.

In order to pass the cost-benefit test and satisfy the intent of the *CFMA*, the SEC should amend its rule change proposals to allow for a less costly and more inclusive registration process for futures intermediaries.