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CONCERNING THE
HARMONIZATION OF FUTURES AND SECURITIES REGULATION

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I am William J. Brodsky, Chairman and Chief Executive Officer of the Chicago Board Options Exchange, Inc. (CBOE). For the past 35 years, I have served in leadership roles at major U.S. stock, futures and options exchanges, including 11 years as CEO of the Chicago Mercantile Exchange and the past 12 years in my current role as CBOE Chairman and CEO.

Exchange-traded options have become a major component of the U.S. -- and the world's -- financial markets. In 2008, over 3.6 billion options contracts traded on the seven U.S. options exchanges, an increase of 25% over 2007. This was the fifth consecutive year that volume growth has exceeded 25%. The annual number of contracts traded has tripled over that five-year period, outstripping the growth in both stock and futures trading. This dramatic growth is a reflection of the expanding use of options as a tool for managing the risk of owning stocks, Exchange Traded Funds (ETFs) and mutual funds and also reflects the highly competitive environment in which exchange-traded options are traded.

In addition to my role at CBOE, I am currently serving as chairman of the World Federation of Exchanges (WFE), a 49-year old organization, which is based in Paris and includes over 50 of the world's major regulated stock, futures and options exchanges. WFE promotes the highest standards of market integrity by working on a global basis with policy makers, regulators and government organizations for fair, transparent and efficient markets. The fact that the CEO of a derivatives exchange has been elected Chairman of the WFE for the first time illustrates the heightened role that exchange-traded derivatives now play in the global financial system.

Throughout my career at exchanges, I have witnessed and participated in many meaningful improvements in the efficiency, functionality and value of our exchange markets. Following the 1987 stock market crash, U.S. exchanges made significant enhancements to market infrastructure and resiliency, but very little changed in the way of regulatory oversight despite the Brady Report, the seminal presidential study of the crash, which found that our regulatory system was already sorely outmoded when the markets fell precipitously in 1987.[1]

The regulatory system deemed antiquated in 1987 remains in place today, but now labors under the weight of increasingly sophisticated technology and instruments that trade around the world in less than a blink of an eye. The ongoing failure to

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[1] See *The Wall Street Journal* op-ed of October 19, 2007, "A Real Regulatory Redundancy."

modernize our regulatory system has resulted in a disjointed, overlapping situation that causes bottlenecks in some markets, unregulated gaps in others, and lacks an overarching regulatory perspective.

While reasonable people may disagree on the best ways to create a 21st century system for market regulation, there is clearly a national consensus that retaining the status quo is not an option. For that reason, we were gratified the Administration's proposal for financial regulatory reform ("Reform Proposal") included the recommendation that the Commodity Futures Trading Commission ("CFTC") and the Securities and Exchange Commission ("SEC") work towards harmonizing their respective statutes and regulations. We strongly support the Administration's recommendation that the statutory and regulatory regimes for futures and securities be harmonized to reduce the disparities between these two important agencies.

We commend the CFTC and SEC for acting promptly to initiate discussions on regulatory harmonization, and I am honored to share CBOE's perspective in my testimony today.[2] My testimony will focus primarily on the harm caused by split jurisdiction between securities and equity-related futures in the U.S. and the means by which harmonization can help address those problems. Since the enactment in 1974 of amendments to the Commodity Exchange Act ("CEA"), which gave the CFTC jurisdiction over all futures, there have been conflicts between the CFTC and the SEC as to their respective jurisdictions, particularly involving financial instruments that have elements of both securities and "commodities." This conflict is a result of divided jurisdiction in which the SEC has oversight of "securities," including stocks, bonds, mutual funds and options on these instruments or an index of such instruments, while the CFTC has jurisdiction over "commodities," which is very broadly defined and includes futures on securities indexes or government securities.

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[2] Both CFTC Chairman Gensler and SEC Chairman Schapiro recently have expressed support for a harmonization effort. See, e.g., Oral Testimony of Chairman Gary Gensler, Commodity Futures Trading Commission, Before the House Financial Services Committee, July 22, 2009, where Chairman Gensler states "President Obama last month called for recommendations for changes to the statutes and regulations that would harmonize regulation of the futures and securities markets. I believe that is essential." See, also, Testimony of Chairman Mary L. Schapiro, U.S. Securities and Exchange Commission, Before the United States House of Representative, Committee on Financial Services, July 22, 2009, where Chairman Schapiro notes that "we appreciate the benefits that could be achieved through greater coordination and harmonization between the SEC and the CFTC for regulation and oversight of economically equivalent instruments."

The Reform Proposal clearly outlines that, as a result of the differing missions of the SEC and CFTC, as well as the separate statutes under which they operate, futures and comparable securities products are not regulated in a consistent manner. These inconsistencies have led to conflicts between the agencies over new products, clearing and portfolio margining. The two agencies also have different approaches to margin levels, default, malfeasance, bankruptcy, insolvency, insider trading and other investor protection issues. These disparities have created competitive inequalities between the securities and futures markets and have resulted in unintended but, nonetheless, negative consequences for investors and for our ability to compete in a global marketplace. The remainder of this testimony highlights specific differences in the approaches of the two agencies and offers suggested ways in which the SEC and CFTC might harmonize regulation to reduce the negative impact of these inherent disparities.

Differing Approaches to Regulation

The operating principles guiding the SEC and CFTC are fundamentally different. Since the passage of the Commodity Futures Modernization Act of 2000, the CFTC has operated under a "principles-based" regulatory approach for the exchanges and clearing organizations under its jurisdiction. The CEA sets forth separate sets of "core principles" for exchanges and clearing organizations. While all futures exchanges and clearing organizations must adhere to the core principles applicable to them, they are given considerable discretion in determining how they will do so. This more flexible principles-based approach is used extensively by European regulators. In contrast, securities exchanges and clearing organizations are subject to a "rules-based" regulatory approach under the SEC whereby they and their members are required to comply with a number of specific and prescriptive regulations. While the SEC and CFTC should discuss the pros and cons of each approach, we support the Administration's proposal that the SEC give serious consideration to shifting closer to a principles-based approach for exchanges and clearing organizations under its jurisdiction.

Oversight of Self-Regulatory Organizations ("SROs")

A prime example of the different regulatory approaches of the CFTC and SEC is how each oversees the SROs under their respective jurisdictions. The CFTC's risk-based approach to oversight of SROs sets regulatory objectives for regulated entities and focuses its attention on areas posing the most risk. Under this approach, SROs are free to establish or change their own rules with the requirement only that they certify with the CFTC that the proposed rule change is in compliance with the CEA. Upon receipt of a self-certification, the CFTC can decide whether or not to conduct a full review of the proposal. This structure enables SROs to implement business decisions promptly, yet permits the CFTC to concentrate on proposals that present significant regulatory issues.

In contrast, the SEC's mechanical rules-based approach dictates very specific market rules and maintains a prosecutorial orientation on failures to comply with detailed rules. As a result, the SEC employs an outdated structure where SROs must submit all proposed rule changes to the SEC, with the majority automatically being subject to an extensive SEC review. The differences in the review process significantly disadvantage securities SROs in three ways. First, it often causes substantial delays for securities SROs in introducing new products. While futures SROs can start a new product very quickly through a self-certification process, many new securities products have to undergo an extensive SEC review process that can take months or, in some cases, more than a year. Second, securities SROs are similarly delayed by the rule change review process in making changes to their operations. Third, securities SROs can be subject to arbitrary standards imposed during the SEC review process.

This disparity between the two approaches poses severe domestic and international competitive disadvantages to securities SROs and inhibits innovation in the securities markets. The best way to harmonize the two approaches is for the SEC to adopt a process for handling SRO rule changes that resembles the CFTC certification process.

New Products

CBOE is known throughout the world for product innovation and has engineered virtually every major options innovation since launching the options industry in 1973. It is not surprising, therefore, that the most vexing aspect of split jurisdiction for CBOE is the delays that result in bringing new products to market. Legal uncertainties frequently arise when a novel aspect of a proposed new securities derivative product causes the CFTC to claim that the product has elements of a futures contract, or a novel aspect of a new futures product causes the SEC to claim it is a security. This can result in an interminable delay in bringing a new product to market while the two agencies try to decide who has jurisdiction over the instrument -- or worse -- when it takes a multiyear court process to resolve the issue.

Product delays have occurred repeatedly over the past 20 years. For example, in the recent past, CBOE had two new product proposals -- one involving an option on an exchange traded fund (ETF) that holds investments involving gold and one involving an option on a credit default product -- both placed on hold for an extremely long period of time (3½ years in the case of Gold ETFs and 7 months for the credit default product) because the two agencies could not agree on jurisdiction. In contrast, Eurex (Europe's largest derivatives exchange) was able to introduce a credit default product in Europe within weeks of announcing its intention to do so, and well before the U.S. exchanges had approval to introduce their credit default products in the U.S. due to the disagreement between the two agencies.

Currently, there is no real mechanism in place to resolve jurisdictional disputes. This has led to long delays in the decision-making process, which hinders competitiveness to the detriment of investors and our markets. This is not intended to imply that either agency is not putting forth a good-faith effort toward the resolution of such impasses. Each is earnestly applying its respective statute when analyzing a particular jurisdictional issue. The impasses that frequently arise are the natural result of differing and, sometimes, conflicting philosophies of the securities laws and commodities laws. However, no matter how well intentioned the agencies are, a neutral arbiter is needed to resolve disputes in a timely manner.

We believe that a process needs to be implemented whereby a quick and decisive resolution to jurisdictional disputes can be obtained. One approach would be to use the Treasury Department as a tiebreaker in jurisdictional disputes. Treasury is well versed in the issues typically presented in jurisdictional disputes and is well suited to resolve them. Another possible approach would be to use the President's Working Group on Financial Markets or, if the Reform Proposal is adopted, the Financial Services Oversight Council ("FSOC") for resolution of jurisdictional disputes. Regardless of whether Treasury or the FCOC is used, we believe that an SRO should be able to petition the tiebreaker directly if one of its new product proposals is caught in a jurisdictional disagreement between the two agencies. Prompt resolution of jurisdictional disputes is vital to quickly bringing new products to market, to implementing new market mechanisms, and to the ability of the U.S. capital markets to compete in a global marketplace.

Legal uncertainties caused by duplicative regulation also impede the clearing of new products. The Options Clearing Corporation ("OCC"), the clearing agency for the seven U.S. options markets and the world's largest derivatives clearing house, clears exchange-traded derivative products and is registered with both the SEC and the CFTC. OCC clears securities options, which are under the jurisdiction of the SEC, security futures, which are jointly regulated by the SEC and CFTC, and futures, which are under the jurisdiction of the CFTC. OCC is the only U.S. clearing organization able to clear all of these products within a single clearing organization, which provides for greater operational efficiency and, thus, reduces systemic risk in the clearing and settlement process. However, because of its dual registration, OCC is subject to the jurisdiction of the CFTC, as well as that of the SEC, every time it introduces a new securities option product.

The CFTC operates under a self-certification process by which OCC could certify that a particular new product does not fall within the jurisdiction of the CEA. However, in cases where there is ambiguity as to where the jurisdictional line lies, OCC has been compelled to seek prior approval from both agencies in order to avoid the risk of litigation after trading has begun. Forcing OCC to operate under this cumbersome process inhibits the benefits of common clearing by a third-party guarantor, which were so dramatically highlighted by the recent crisis. By contrast, futures exchanges and their captive clearing houses have no concomitant need to pre clear their new products with the SEC.

An interim step to address this problem would be to use Treasury in the tiebreaker role described. Rather than ask for prior approval from both agencies to clear a new product, OCC could rely on Treasury's disposition of a SEC–CFTC disagreement on a new product. For example, if Treasury determines that a new derivative product to be cleared by OCC should be regulated as a securities product, then OCC would not need to ask for prior approval from the CFTC to clear it.

Market Structure

The securities markets are subject to a comprehensive series of market structure statutory provisions, rules, and interpretations. For example, Section 11A under the Securities Exchange Act of 1934 provides a panoply of market structure objectives and requirements. To effectuate these provisions, the SEC has issued rules and interpretations regarding market transparency, best execution, trade throughs, and intermarket competition. The commodities laws do not contain similar provisions. As a result, the futures exchanges operate without the same degree of government involvement in market structure or related issues. Not surprisingly, the nature of intermarket competition is very different in the securities markets than in the futures markets. The CFTC and SEC should discuss whether it makes sense for the securities and futures markets to have such different treatment with respect to market structure issues.

Margins

The problems resulting from divided jurisdiction go beyond our pressing concerns about legal uncertainty for new products. U.S. financial firms are subject to duplicative and disjointed oversight from separate agencies when trading virtually equivalent products, such as stock index options and stock index futures. Key investor protection and market soundness provisions, such as margin levels, are handled very differently by the two agencies for similar products.

The different approaches to the setting of margin levels between the SEC and CFTC have a significant impact on competition between the securities and futures markets. Futures markets set margin levels without real CFTC involvement. In contrast, initial stock margin levels are set by the Federal Reserve and the SEC, and equity options margin levels, while proposed by the exchanges, must be approved by the SEC. One consequence of these different approaches is that futures margin levels have been consistently much lower than margin levels required in the securities markets (except for security futures, which are jointly regulated by the SEC and CFTC). For example, stock index futures margin levels often have been 5 percent or less of the contract value. Yet, for stock index options, purchasers must pay the full purchase price while sellers must post margin equal to the premium received plus 15-20 percent of the index value. Other areas where treatment of margin for futures products is more lenient compared to equivalent securities products include differences in the type of collateral posted for margin and the instruments permitted to act as margin offsets.

The differences in margin levels found in the options markets and in the stock index futures markets have a direct and palpable effect on competition between the two marketplaces. Lower margin levels provide futures with a cost advantage over options that is not justified by differences in the risks between the two products. The result is that equivalent products do not compete on a level playing field solely because they are subject to separate margin oversight. To resolve this, all equity derivatives margin should be subject to the same standards and process of oversight.

Another area of margins regulations we would like to see addressed involves portfolio margining. In 2007, the availability of portfolio margining was greatly enhanced for securities customers, including those who trade security futures, through expansion of an existing portfolio margin pilot program approved by the SEC. This expanded pilot includes equity options, security futures and individual stocks as instruments eligible for portfolio margining. The pilot enhances U.S. competitiveness by bringing the benefits of risk-based margining employed in the futures markets, and in most non-U.S. securities markets, to U.S. securities customers. The exchange rules adopting this pilot also authorized the inclusion of related futures positions in securities customer portfolio margining accounts.

The ability to margin all related instruments in one account would allow customers to fully realize the risk management potential of these instruments in a way that is both operationally and economically efficient. However, legal impediments that prevent putting futures positions in a securities customer portfolio margining account significantly undercuts the ability of customers to fully realize the capital efficiencies of portfolio margining. For more than four years, the SEC and CFTC have been unable to agree on how to permit futures to be included in a securities portfolio margin account. Because the two agencies continue to disagree on the most appropriate approach, the ability of many customers to employ portfolio margining between futures and securities has been stymied. Unless this deadlock is broken, portfolio margining will not reach its full potential in the United States, even though it is used in many jurisdictions abroad. As a first step in resolving this disparity, Congress would need to amend the Securities Investor Protection Act (SIPA) to allow broad-based index futures to be treated as securities when included in an SEC-regulated portfolio margining account. The CFTC would then need to provide an exemption from the segregation requirements of the CEA for futures positions held in a securities portfolio margining account. Another step would be for the CFTC to permit a portfolio margin account to be established using the "one pot" clearing method utilized in the securities markets.

Customer Protection and Market Integrity

There are several areas where the securities laws are more vigorous than the futures laws in promoting customer protection and market integrity. First, the securities laws contain strong prohibitions against corporate insiders trading on the basis of material, non-public information. The CEA does not prohibit insider trading even on securities-based futures, other than on single stock futures. The lack of an insider trading prohibition for CFTC products potentially enables a miscreant to use such instruments to engage in transactions using inside information when otherwise prohibited from doing so using securities. This disparity will take on increasing importance with the growth of credit-related instruments. Second, the securities laws and SRO rules impose suitability requirements on broker-dealers making recommendations to customers, including heightened suitability standards for options transactions. The CFTC does not impose a suitability requirement, nor do the futures exchanges or the National Futures Association ("NFA"), except for single stock futures. There is no legitimate policy reason to apply disparate insider trading and suitability rules on securities-based futures as opposed to securities themselves. The prudent resolution to resolve this disparity would be to strengthen futures laws along the lines of the provisions that apply to securities options.

Bankruptcy and Insolvency

The securities and futures laws also differ on the procedures for broker insolvency. The securities laws generally require brokers to join the Securities Investor Protection Corporation ("SIPC"), which assesses its members fees to create a fund to be used in case of a broker insolvency. The fund reimburses customer losses up to a certain limit. In addition, the SEC's customer protection rules require brokers (a) to have physical possession or control of all "fully-paid securities" and "excess margin securities" carried for customer accounts and (b) to maintain a "Special Reserve Bank Account" for the exclusive benefit of customers in which the broker must maintain an amount of funds calculated pursuant to a formula specified in SEC rules.

The CEA does not provide for SIPC-type insurance protection for futures customers. The CEA does require strict segregation of customer funds from the funds of the futures commission merchant ("FCM") holding the account. The customer funds must be held in a separate bank account that is clearly designated as belonging to customers. This ensures (1) that the FCM does not commingle customer funds with its own funds and (2) that, in the event of an FCM bankruptcy, customer funds would be identified as such and would not be available to other creditors of the FCM.

This disparity poses conflicting insolvency treatments for an entity that is both a broker-dealer and a FCM. It also complicates efforts to address default or malfeasance by a large market participant, as evidenced by the different approach the two agencies took two years ago with respect to the problems surrounding the failure of Sentinel Management Group, Inc.[3] In harmonizing the futures and

[3] Sentinel was both an investment adviser registered with the SEC and a futures commission merchant registered with the National Futures Association. When questions arose as to the disposition of certain funds held by Sentinel on behalf of various futures commission merchants (FCMs) and other clients, the SEC and the CFTC took very different positions. While the SEC sought to freeze the proceeds in all Sentinel accounts (which it asserted had been improperly commingled) for the ultimate benefit of injured investors (including, but not limited to, the affected FCMs), the CFTC sought to ensure that the FCMs were given access to their (or their customers') funds that had been in a segregated account in order to preserve the integrity of the futures markets and prevent a potentially broader, market-wide collapse.

securities laws, attention should be given to whether the bankruptcy structures should continue to be so dramatically different for securities and futures accounts. If the two separate structures are kept in place, then attention should be given to how best to reconcile the differences when a dual broker-dealer/FCM becomes insolvent.

Conclusion

CBOE believes that the joint CFTC–SEC harmonization project provides a unique and timely opportunity to bring needed changes to the U.S. regulatory landscape in order to promote investor protection and the competitiveness of U.S. financial markets.

CBOE, WFE, and I, personally, stand ready to work with the two agencies and their staff as they consider these important issues. Thank you again for the opportunity to testify at this important hearing. I would be happy to answer any questions you may have.