Testimony of Larry Leibowitz
NYSE Euronext
Joint SEC and CFTC Hearing
Harmonizing Market Regulation
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Chairman Gensler, Chairman Schapiro, and SEC and CFTC Commissioners, my name is Larry Leibowitz, and I am Group Executive Vice President and Head of U.S. Execution and Global Technology for NYSE Euronext. As a regulated entity of both agencies, I am pleased to appear before you today to share my views on ways to improve and harmonize the financial services regulatory structure in the United States.

NYSE Euronext is a leading global operator of financial markets and provider of innovative trading technologies. The company's exchanges in Europe and the United States trade equities, futures, options, fixed-income and exchange-traded products. With more than 8,000 listed issues, NYSE Euronext's equities markets -- the New York Stock Exchange, Euronext, NYSE Arca and NYSE Amex -- represent nearly 40 percent of the world's equities trading, the most liquidity of any global exchange group. NYSE Euronext also operates NYSE Liffe, one of the leading European derivatives business and the world's second-largest derivatives business by value of trading, and NYSE Liffe US, which is registered as a U.S. designated contract market with the CFTC. Moreover, we recently launched NYSE Liffe Clearing to provide clearing for our London derivatives market. The company also offers comprehensive commercial technology, connectivity and market data products and services through NYSE Technologies. Our exchanges are regulated by their respective home country regulators and in Europe, our markets are also regulated by a college of regulators which serves to coordinate European regulatory oversight. The diverse asset classes and broad geographic range of NYSE Euronext provide us with a unique perspective on the issues we are discussing with you today.

Regulation is an integral and important part of the NYSE Euronext business structure. It is our belief that smart regulation—when properly administered—adds value to our business model. We applaud your agencies for calling these hearings in an effort to improve regulatory oversight in the U.S.

One of the lessons from the recent financial crisis is that gaps in regulation—particularly with over-the-counter derivatives—can result in devastating consequences for consumers and the global economic landscape. But this financial crisis has also highlighted that the exchange-traded and cleared model—both in securities and futures—has held up extraordinarily well as unregulated markets have faltered. With this in mind, NYSE Euronext supports the Administration's proposal to bring standardized derivatives onto exchanges and clearinghouses for the transparency and credit mitigation benefits that such structures provide.

However, with new and diverse products coming onto regulated markets and clearinghouses, this moment—defined by the recent crisis—provides us an opportunity to construct a better and more coordinated approach to regulation. The U.S. deserves a 21st century regulatory system to match its world-class capital and risk markets. As these markets innovate and become increasingly intertwined, the need for enhanced collaboration and cooperation between the SEC and CFTC becomes increasingly evident. There are several steps that can help in coordinating the missions of these important agencies.

Recommendation One: The agencies should adopt an overarching set of principles for exchange regulation to guide both agencies and self-regulatory organizations in their coordinated oversight of these markets.

Both securities and futures regulation are founded on a system of self-regulation in which exchanges, subject to the oversight and supervision of Federal regulators, are vested with statutory authority to adopt and enforce rules necessary to serve as front-line regulators of their markets. This self-regulatory system has worked well over the years in both the securities and commodities industries.

However, the regulatory philosophies pursuant to which the SEC and CFTC approach their supervisory responsibilities differ significantly, with tangible consequences for the exchanges that fall under their respective jurisdictions. As you know, the SEC is founded on a rules-based compliance regime, which requires regulated exchanges to file amendments with the SEC for approval of changes to its rules, trading platform and products. The CFTC, on the other hand, follows a principles-based system, codified with the enactment of the Commodity Futures Modernization Act in 2000, which provides core principles for regulated markets with accompanying "acceptable practices" that serve as non-exclusive safe harbors for compliance.

While the rules-based approach offers enhanced legal certainty for registered entities to ensure that they are in compliance with the law, a principles-based approach provides the benefit of flexibility to the marketplace as exchanges innovate and evolve over time. Both the predictability of rules and the flexibility of principles are important policy goals for effective capital and risk management markets.

NYSE Euronext recommends that the SEC and CFTC adopt one set of over-arching principles for the regulation of both futures and securities exchanges with the authority to adopt joint rulemakings or "acceptable practices" to detail the means for compliance with these unified principles. In doing so, the agencies should strike a balance between the flexibility inherent in a principles regime and the legal certainty that rules or "acceptable practices" provide. These principles should be comparable to and consistent with the International Organization for Securities Commission (IOSCO) principles for securities regulation and screen based trading to ensure a more consistent alignment of regulation across global markets.

With the goal of informing and safeguarding investors from wrongdoing and upholding the integrity of the marketplace, these principles should encompass the fundamental tenets of effective regulation, including that regulation be judiciously administered based on risk and function, rather than legal structure; that regulation promote open, fair and transparent markets; and that regulation seek to promote fair and reasonable competition that is consistent with protecting the public.

Recommendation Two: NYSE Euronext recommends that the SEC adopt a rule and product certification regime similar to the CFTC or make amendments to its current regime that creates greater predictability, fairness and flexibility.

Under this system of self-regulation, the SEC and CFTC have conflicting approaches to approving exchange rules and products. The Commodity Exchange Act (CEA) enables designated contract markets to either certify for immediate effectiveness that the rule and product changes are in compliance with the CEA or to submit rule and product changes for approval with the CFTC under given time limits. Upon receipt of a rule or product certification, the CFTC has the ability to conduct a more robust review of the submission if more information is needed. Under this approach, either path chosen by an exchange provides them with a predictable and fair course for determining whether a rule is in compliance with the law.

The SEC, however, follows a rules-based regulatory approach, which requires exchanges to file new rules and products and any amendments to them with the SEC for approval. While a limited number of rules are eligible to be effective upon filing, the vast majority of rules are subject to a sometimes lengthy review process prior to their approval and implementation. The rules-based approach has led to significant delays in the implementation of some rules at exchanges, as well as deferral or outright loss of new product innovation of exchange-traded products, many of which ultimately end up in the OTC market. This approach also accentuates the unlevel playing field among different trading platforms for securities—many of which do not have self-regulatory responsibilities and are not required to file rule changes with the SEC. Ironically, these lengthy filings often tip off market competitors to business ideas that regulated exchanges are trying to implement, allowing them to freely and quickly benefit from the efforts endured by regulated exchanges without shouldering any responsibility for the associated regulatory burdens, such as intermarket surveillance.

NYSE Euronext recommends that the SEC create greater predictability, fairness and flexibility in its rule and product approval regime by adopting a certification regime similar to the CFTC. As an alternative, the SEC could improve its current system by setting strict time limits on rule and product approvals and by increasing the number of rules or products that are eligible for the "effective on filing" status. We agree that exchanges certifying that a rule or product is in compliance with underlying laws and regulations bear the burden and responsibility for providing documentation of such compliance upon certification and that the power to abrogate these rules should remain with the agencies under such a system.

Recommendation Three: The agencies should work to adopt a more uniform customer account and bankruptcy regime that serves to protect customer assets, uphold the integrity of the clearing system, and provide market participants with risk-based portfolio margining.

As more OTC derivatives come onto exchanges and clearinghouses, the importance of developing and implementing a more uniform customer account regime that protects both customer assets as well as the integrity of the market in the event of a default of a major firm has become all the more evident. Currently, the securities and futures laws differ on the procedures to be followed in the event of the insolvency of a broker-dealer (BD) or futures commission merchant (FCM). The securities laws create an insurance system that requires BDs to join the Securities Investor Protection Corporation ("SIPC"), which assesses its members to create a fund to be used in case of an insolvency of a broker. A SIPC-appointed trustee oversees the liquidation of the insolvent BD.

The futures laws, on the other hand, require FCMs to segregate customer funds from the funds of the FCM holding the account. These segregated funds receive preferential treatment in a bankruptcy proceeding. A Bankruptcy Court-appointed trustee oversees the liquidation of an FCM, following the CFTC's Part 190 rules.

These differences were brought to light most recently last fall when Lehman Brothers Inc.—a jointly regulated BD/FCM—filed for bankruptcy. Fortunately, we avoided a potential crisis, since the sale of customer assets to Barclays Capital had been arranged before the broker-dealer/FCM filed for bankruptcy. However, we cannot assume that our luck will continue to hold. In the absence of a complete overhaul of the provisions of the Bankruptcy Code relating to the liquidation of stockbrokers and commodity brokers, it is essential that the SEC and CFTC develop procedures to guide a trustee, as well as the Bankruptcy Court, when a joint BD/FCM becomes insolvent.

In developing ways to harmonize the futures and securities bankruptcy regimes, there are other steps that can be taken. First, the agencies should look to past precedent and consider the model implemented in the joint regulation of security futures products (SFPs), which allowed certain BDs and FCMs to hold customer SFPs in either a securities account with SIPC protection or a futures account with full segregation safeguards. Such a change would allow futures on the S&P 500 index to reside in the same portfolio as the ETF on the S&P 500 index with the resulting efficiencies for the markets and regulators. Providing investors with greater choice and control in how their investments are protected is sound public policy.

In the long run, the agencies should look to create a new unified account regime that adopts the best of both systems and allows for futures and securities to be located in the same location. This would provide a surveillance benefit for regulators since they would be able to monitor a larger segment of positions in the market. Market participants would also benefit from the efficiencies of holding their hedged positions in one account and the resulting capital efficiencies.

We believe that such changes would have immediate and positive effects in the markets as evidenced by our recent initiative. In June, NYSE Euronext and DTCC announced their intention to form New York Portfolio Clearing—a joint venture that will allow firms that hold both cash positions at the DTCC and futures positions on NYSE Liffe US to receive risk-based portfolio margining. Should this venture be successfully launched, regulators will be able to monitor a more holistic view of the markets and identify positions of firms with large exposures that may not have been visible to them under the current segregated margin environment. If over-the-counter products migrate to this clearinghouse model, the comprehensive view of regulators across asset classes will be even more complete. Should it receive regulatory approval, NYPC will initially be available only to the house accounts of firms, which does not run afoul of any SIPC or segregation requirements. However, we eventually hope to expand this benefit to other customers and investors and look forward to working with regulators to find a consensus solution that both protects customers and the markets while providing risk-based margining.

Recommendation Four: The agencies should build on last year's Memorandum of Understanding (MOU) for Novel Derivatives Products to develop a more robust and predictable process for approving products that have attributes of both securities and futures.

The present split of jurisdiction between the CFTC and SEC creates confusion regarding who should review or approve the listing and trading of new derivatives products that may have elements of a futures and a security. All too often, the result is a lengthy delay in the listing of new or novel products that would benefit investors. One example of this delay was in the listing of options and futures on the SPDR Gold Trust ETF. The listing of options on GLD and futures on GLD were delayed for over a year due to legal uncertainty on whether such products were securities or futures. This delay to market and uncertainty has increasingly driven issuers to list these products on foreign or OTC markets outside our regulatory view.

Last year the agencies took positive steps to overcome this legal quagmire. In March 2008, the agencies signed a Memorandum of Understanding on Novel Derivative Products that created points of contact at each agency, set regular staff meetings to discuss mutual developments, and outlined principles and a process for approving such novel derivatives products. This MOU eventually led to the approval of the two novel derivatives products discussed above—the futures and options on the SPDR Gold Trust ETF – but has not altogether resolved the issue between the agencies.

Nevertheless, NYSE Euronext believes this process can be improved by developing express timelines for approval once a product is subject to such process and a mechanism for final arbitration should the agencies become deadlocked in their discussions, such as outlined in the Administration's recent recommendations on derivatives legislation. Such improvements will ensure that products are able to come onto regulated U.S. markets in an expeditious manner for the benefit of the investing public.

In addition, certain foreign products for U.S. investors continue to fall between the jurisdictional cracks of the agencies. While we were pleased that the SEC issued a unilateral order earlier this year authorizing the limited offer and sale of security futures products traded on a foreign exchange, it has proven to be too narrow to provide meaningful relief for most investors. In enacting the CFMA in 2000, Congress instructed the Commissions to "jointly issue such rules, regulations, or orders as are necessary and appropriate to permit the offer and sale of a security futures product traded on or subject to the rules of a foreign board of trade to United States persons." We hope the Commissions will address this long-overdue Congressional mandate to find a joint and agreeable solution that allows these products to trade.

Recommendation Five: NYSE Euronext recommends the agencies work to develop a coordinated "mutual recognition" approach to global regulation that allows cross-border markets to exist subject to high global regulatory standards.

NYSE Euronext is uniquely positioned as a global regulated exchange to discuss the difficulties associated with cross-border regulation among multiple jurisdictions. While global regulators must continually strive to develop common rules between jurisdictions, such agreements take significant time and may not be possible due to special or historical legacies in given jurisdictions. In fact, the jurisdictional split between the SEC and CFTC being discussed today is one such issue that is specific to the United States due to the manner in which our markets developed and that other global regulators do not face.

The "mutual recognition" concept enables global regulators to recognize these unique differences among jurisdictions and provide access to those foreign jurisdictions as long as they abide by comparable—rather than identical—regulatory standards. The SEC took important steps on this front last year with its recognition pilot program with Australia. And the CFTC has long been a leader in the international community for its early appreciation of the "mutual recognition" concept, dating back to the inception of its Part 30 regime for foreign firms in 1987 and the no action process beginning in 1999.

Without such a recognition system, registrants are subject to multiple and often conflicting regulatory requirements around the world without measurable benefits for the investing public. Of course, such a system must allow for robust information sharing and cooperation between jurisdictions and be flexible enough to allow home country recognition to be conditioned on the fulfillment of certain limited requirements in an effort to protect domestic investors and markets from malfeasance. Our London derivative exchange—NYSE Liffe—has been operating under the CFTC's no-action recognition program since 1999 without incident. We encourage both agencies to continue to embrace and advance this concept going forward.

In conclusion, NYSE Euronext is committed to partnering with your agencies as you move forward to reconcile and improve the U.S. regulatory system. We believe that this process would benefit from periodic joint meetings of the Commissions such as the one being held today. In addition, NYSE Euronext believes that joint advisory committees or industry "blue ribbon" panels can be utilized to help find workable solutions for many of these technical and complex legal issues and we stand ready to assist in those efforts. Thank you again for the opportunity to testify and I welcome any questions that Commissioners may have.