Memorandum Concerning the Securities and Exchange Commission and the Commodity Futures Trading Commission

---

JOHN CRAWFORD
TIM KARPOFF
ANGELA ALLEN
NICOLE ALLEN
MICHAEL MARGOLIS

This paper was prepared for the Volcker Alliance as background for its project on structural reform of the federal financial regulatory system. The views expressed in this paper are those of the authors and do not necessarily reflect the position of the Volcker Alliance. Any errors or omissions are the responsibility of the authors.

Mr. John Crawford is an associate professor at the University of California, Hastings College of Law. **Mr. Tim Karpoff** is a partner at the law firm of Jenner & Block, and previously served as Counsel to the Chairman of the Commodity Futures Trading Commission and as Director of the United States Department of the Treasury's Office of Financial Institutions Policy. **Ms. Angela Allen**, **Ms. Nicole Allen**, and **Mr. Michael Margolis** are associates at Jenner & Block.

PURPOSE

This memo aims to support the Volcker Alliance’s project on financial regulatory reform by providing a comprehensive descriptive account of the Securities and Exchange Commission (SEC) and the Commodity Futures Trading Commission (CFTC): their structure; their authorities and tools of enforcement; the markets, products, entities, and activities they regulate; regulatory challenges they face; and potential approaches to structural reform.

I. THE SECURITIES AND EXCHANGE COMMISSION

A. Background

The Securities and Exchange Commission (SEC) is the chief regulator of the nation's capital markets, dedicated to a three-fold mission: protecting investors; maintaining fair, orderly, and efficient markets; and facilitating capital formation.[1]

The "SEC" can refer both to the five-member Commission that votes on rules and to the administrative agency as a whole.[2] The five members of the Commission are each appointed by the President and confirmed by the Senate, and serve (staggered) five-year terms. One member of the Commission is designated as Chairman, and no more than three of the commissioners can be from the President's political party. The current commissioners are Mary Jo White (chair), Luis Aguilar, Daniel Gallagher, Kara Stein, and Michael Piwowar.[3]

Both the Commission and the agency were established by the Securities Exchange Act of 1934 ('34 Act). For the first decade-and-a-half of its existence, the five commissioners "met almost daily and acted on virtually every decision that had to be made."[4] In 1950, "Reorganization Plan No. 10"[5] assigned all executive functions to the Chairman of the Commission. Congress amended the '34 Act in 1962 to allow the Commission to delegate authority to the agency staff. Since that time, virtually all authority except rulemaking[6] and certain enforcement decisions have been delegated to staff.[7]

Even aside from this formal delegation, the ability of the commissioners, other than the chairman, to play a meaningful role in the commission's work is severely constrained by the Government in the Sunshine Act (Sunshine Act) of 1975.[8] The law, aimed at increasing transparency, requires (with limited exceptions) that any time two or more commissioners meet with staff to discuss Commission business, it be done in a public forum.[9] While staff can meet

---

1 U.S. Securities and Exchange Commission, FY 2015 Congressional Budget Justification, FY 2015 Annual Performance Plan, FY 2013 Annual Performance Report 8 [hereinafter CBJ 2015], available at http://www.sec.gov/about/reports/secfy15congbudgjust.pdf.

2 Richard Scott Carnell et al., The Law of Financial Institutions (5^{th} ed.).

3 *Current SEC Commissioners*, SEC website, http://www.sec.gov/about/commissioner.shtml#.VCXLyxa6_2Y

4 Jonathan Katz, *Examining the Efficiency and Effectiveness of the U.S. Securities and Exchange Commission* at 17, Center for Capital Markets Competitiveness (Feb. 2009) [hereinafter Katz 2009], available at http://www.centerforcapitalmarkets.com/wp-content/uploads/2013/08/ExaminingtheSECrdcfinal.pdf.

5 Reorganization Plan No. 10 of 1950, available at http://uscode.house.gov/view.xhtml?req=granuleid:USC-prelim-title5a-node83-leaf113&num=0&edition=prelim.

6 Rulemaking cannot be delegated in the sense that rules can only be proposed or finalized by a majority vote of the commissioners. Of course, the rules the commissioners vote on are drafted by staff, who can thus shape to a large degree the contours of the rules that the commission eventually votes on.

7 Katz 2009, supra note 4, at 17.

8 *U.S. Securities and Exchange Commission: Organizational Study and Reform* at 37, Mar. 10, 2011, prepared by the Boston Consulting Group (BCG) [hereinafter BCG Report], available at https://www.sec.gov/news/studies/2011/967study.pdf.

9 *Id.*

with one commissioner at a time, or provide non-public briefings to multiple commissioners as long as the commissioners refrain from substantive discussion,[10] "[v]irtually every commissioner who has served since 1975 has commented or expressed frustration over [their] inability to meet confidentially with the staff to discuss division operations, activities, and decisions."[11] In contrast to the other commissioners, the Chairman functions as the chief executive officer of the SEC, with broad powers to set agency priorities and affect its resource allocation.

1. History and Statutes

There are eight principal federal statutes that govern the securities industry.[12] The core statutes were passed at the height of the Great Depression. Prior to "Black Tuesday," the stock market crash of Oct. 24, 1929, that marked the beginning of the Depression era, the idea of federally regulating the securities industry lacked serious political support.[13] The crash followed a remarkable surge in the stock market and retail investors' participation in it: "During the 1920s, approximately 20 million large and small shareholders took advantage of post-war prosperity and set out to make their fortune in the stock market. It is estimated that of the $50 billion in new securities offered during this period, half became worthless."[14] The crash shattered public confidence in the stock market. In 1932 and 1933, the Senate Banking and Currency Committee held a series of hearings to investigate the causes of the crash, now known as the Pecora Investigation, after the chief counsel for the investigation, Ferdinand Pecora.[15] Pecora's investigation exposed a variety of "frauds, scams, and abuses that culminated in the 1929 crash."[16] These hearings – along with the general sweep of the New Deal – provided the political impetus for Congress to pass the Glass-Steagall Act, which severed commercial and investment banking,[17] along with the pillars of federal securities regulation: the Securities Act of

10 *Id.*

11 Jonathan G. Katz, *U.S. Securities and Exchange Commission: A Roadmap for Transformational Reform* at 110, Center for Capital Markets Competitiveness, December 2011 [hereinafter Katz 2011], available at https://www.uschamber.com/sites/default/files/legacy/reports/16967_SECReport_FullReport_final.pdf.

12 *The Investors Advocate: How the SEC Protects Investors, Maintains Market Integrity, and Facilitates Capital Formation* [hereinafter *The Investors Advocate*], SEC website, http://www.sec.gov/about/whatwedo.shtml#laws

13 *Id.*

14 *Id.*

15 Ron Chernow, *Where Is Our Ferdinand Pecora?*, N.Y. Times, Jan. 5, 2009.

16 *Id.* One of the most salient abuses emphasized in the hearings was the "crooked stock pool": a "device[] used by brokers and dealers to create a false appearance of trading activity by simultaneously buying the same security they were selling. Innocent investors were attracted to the manipulated stock by its price and volume changes. Eventually, unwitting investors' orders provided all the upward momentum to the stock's price. And, as the price rose, the brokers and dealers behind the scheme dumped their holdings at the higher price created by the unwitting investors' interest. More recent examination of the market prices in the 1920s suggests that the congressional hearings greatly exaggerated the effect and existence of such abusive schemes, perhaps doing so for political purposes." James D. Cox, Robert W. Hillman, and Donald C. Langevoort, Securities Regulation: Cases and Materials (6th Ed.), at 6.

17 The Gramm-Leach-Bliley Act (GLBA) of 1999 repealed the provisions of Glass-Steagall prohibiting the *affiliation* of commercial and investment banks (i.e., broker-dealers). Thus broker-dealers and deposit-taking commercial banks could, after GLBA, be part of the same bank holding company family. The provisions of Glass-Steagall prohibiting the broker-dealer subsidiary from taking deposits, or the commercial bank subsidiary from engaging in investment banking activities, remains largely in place. Dodd-Frank's Volcker Rule, of course, constitutes a *partial* return to Glass-Steagall, prohibiting banks *and* bank affiliates from most types of proprietary trading.

1933 and the Securities Exchange Act of 1934. These statutes were "designed to restore investor confidence in our capital markets by providing investors and the markets with more reliable information and clear rules of honest dealing."[18]

The *Securities Act of 1933 ('33 Act)* provides for the registration of any public offering of securities, and mandates disclosure of material information about the issuer and the securities being offered. (Because the SEC was not created until the following year, registration statements were filed with the Federal Trade Commission (FTC) for the first year after the '33 Act's passage.) Registration forms under the '33 Act require a description of the issuer's business; a description of the security being offered; and financial statements certified by independent auditors.[19] The '33 Act requires registration of securities offerings unless the securities qualify for a statutory exemption. Key exemptions include those for securities issued by governmental entities, banks, and insurance companies;[20] and those for securities sold in "private offerings," defined (among other things) by the number and sophistication of investors, and the process used to solicit their investments.[21]

The '33 Act also prescribes penalties for false or misleading statements or omissions in registration statements. Offerings may also be subject to state securities laws, though the National Securities Markets Improvement Act of 1996 exempted most securities (including, for example, securities traded on national exchanges) from registration requirements under state "blue sky" laws. The '33 Act embodies a disclosure-based regulatory approach, eschewing a merit-based review of offerings.

While the '33 Act focused principally on the primary market, there was a good deal of evidence of problems in the secondary market, as well: for example, false and misleading statements about stocks trading on the secondary market, usually coupled with insiders profiting from confidential inside information; a lack of legally compelled disclosure of material information by public firms; and shortcomings in the proxy solicitation process, leading to a lack of responsiveness by public company boards and managers to their shareholders.[22] These market flaws and abuses propelled the enactment of the Securities Exchange Act of 1934.

The *Securities Exchange Act of 1934 ('34 Act)* created the SEC and assigned it broad regulatory authority over the securities industry. As observed by James Cox and coauthors,

> There is an important difference in style between the Securities Act and the Exchange Act. In the Securities Act, Congress Empowered the Federal Trade Commission (FTC) to

[18] *The Investors Advocate*, supra note 12.

[19] *Id.*

[20] Securities Act §3.

[21] Securities Act §4 and accompanying rules.

[22] Cox et al., supra note 16, at 6.

> discharge a specific and well-defined task: the registration of public company offerings of securities not otherwise exempt from the Act. The means, as well as the end result, are clearly and unequivocally defined in the Securities Act. In contrast, the Exchange Act is in large part a laundry list of problems for which Congress articulated neither the means nor the end objective. Instead, Congress, through Section 4 of the Act, created the Securities and Exchange Commission and delegated to it the task of grappling with the problem areas.
>
> The contrast in style between the two acts bears witness to the fact that compromises were necessary to assure passage of the Exchange Act whereas that was not the case for the Securities Act. Recall that the Congress that enacted the Securities Act also enacted in those heady first hundred days of Roosevelt's first term other legislative packages that greatly centralized the federal government's control over the economy, the most prominent piece being the National Recovery Act.
>
> …
>
> In the end, many of the pressing regulatory issues were unresolved in the '34 Act and were instead dumped into the lap of the newly created Commission, where the debate and the compromise would continue.[23]

The '34 Act not only created the Commission but provided it with the power to register and regulate broker-dealers, transfer agents, clearing agencies, and exchanges.[24] It empowered the SEC to require companies "with more than $10 million in assets whose securities are held by more than a specified number of people" to file periodic reports with the Commission.[25] It mandates various disclosure and procedural rules relating to proxy solicitations and tender offers.[26] And it creates liability for insider trading under Section 10b.[27]

The *Trust Indenture Act of 1939* supplements the '33 Act's requirements for bonds, debentures, and notes sold to the public. It sets standards that must be met for the formal agreement, known as the "trust indenture," between the issuer and the investors.

Two acts governing the asset management industry were enacted in 1940 in the wake of four-year investigation by the SEC.[28] The *Investment Company Act of 1940 ('40 Act)* provides for the regulation of investment companies, defined as companies that "engage primarily in investing, reinvesting, and trading in securities, and whose own securities are offered to the

23 *Id.* at 6-7.
24 *The Investor's Advocate*, supra note 12.
25 *Id.*
26 *Id.*
27 *Id.*
28 Cox et al., supra note 16, at 11.

investing public." Investment companies include mutual funds (including money market funds), closed-end mutual funds, exchange traded funds, business development companies, and unit investment trusts.[29] The '40 Act is more prescriptive than the '33 and '34 Acts, which rely on mandatory disclosure rather than substantive regulation. The '40 Act "regulates the independence of the company's board of directors; requires annual review of any management contract between the investment company and its investment advisor; conditions transactions between the company and its officers, directors, or affiliates upon approval by the SEC; and regulates the capital structure of investment companies."[30]

The *Investment Advisers Act of 1940* regulates investment advisers, or those who advise persons or entities on investment decisions for compensation. Investment advisers who have a minimum of $100 million in assets under management, or who advise a registered investment company, must register with the Commission and adhere to regulations establishing standards of fair dealing and prohibiting deceptive practices.[31]

The *Sarbanes-Oxley Act of 2002* marked a break from the federal government's traditional disclosure-based approach to investor protection.[32] It was enacted in the wake of an extraordinary string of financial and accounting failures, leading to spectacular bankruptcies, in 2001 and 2002. The first to fall was Enron, once a regular at the top of lists of the most admired and most innovative companies in the U.S. When Enron filed for bankruptcy in December 2001, "it was … revealed that Enron's profits were fabricated by its executives, that its Big Five accounting firm, Arthur Andersen, had acquiesced in clear violations of accounting and reporting principles, that it appeared that two national law firms that advised it had not appropriately advised their clients of possible misconduct by senior management, and that financial analysts were co-opted by pressures from their investment banking colleagues to support Enron with 'strong buy' recommendations as a means to garner lucrative investment banking business from Enron."[33] These revelations would directly feed into the reforms of Sarbanes-Oxley, though Enron by itself would likely not have been sufficient to propel the reforms: it was followed in relatively quick succession by a dozen public company failures "where there was strong evidence of reporting violations and audit failures even more egregious" than at Enron, with the final straw occurring in June 2002, as WorldCom revealed a massive accounting fraud and filed for bankruptcy (beating Enron's six-month-old record as the largest in US history).[34]

In response to these scandals, Sarbanes-Oxley included a number of provisions aimed at enhancing auditor independence, bolstering the personal accountability of company officers for

---

29 See discussion below for a description of each.

30 Cox et al., supra note 16, at 11.

31 *Id.*

32 *Id.* at 9.

33 *Id.* at 10.

34 *Id.*

the company's financial statements, increasing the scope and quality of financial disclosures, and eliminating conflicts of interest for securities analysts. The Act also established the Public Company Accounting Oversight Board (PCAOB), a private non-profit authorized to oversee the audits of public companies and broker-dealers. PCAOB "registers, conducts examinations, reviews regulatory reports, and writes rules for all accounting firms that conduct audits of public companies or broker-dealers."[35]

The *Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010* (Dodd-Frank) was, of course, enacted as a response to the worst financial crisis in the United States since the Great Depression, and to the unique impetus for reform the crisis created. The Act included an extraordinarily broad array of provisions touching on most corners of the financial system.

The provisions that affect the SEC include (but are not limited to):[36]

- The establishment of a new Financial Stability Oversight Council (FSOC), which includes the SEC chair as a member;
- The Volcker Rule, which requires the SEC to enforce against certain entities (namely, bank affiliates) under its supervision a prohibition (with certain exceptions) on proprietary trading, as well as on owning or sponsoring private equity and hedge funds;
- The establishment of oversight authority of the swaps market, to be split between the SEC and CFTC;
- The establishment of new registration and reporting requirements for private fund advisors;
- Mandates for heightened regulation of credit rating agencies and asset-backed securities;
- The establishment of five new offices within the SEC, including the Office of Municipal Securities, the Office of Credit Rating Agencies, the Office of the Investor Advocate, the Office of Minority and Women Inclusion, and the Whistleblower Office;
- Reforms to corporate governance and executive compensation disclosures at all public companies, including a "say on pay" provision requiring that public companies hold a periodic nonbinding vote of its shareholders on the compensation packages of its top executives; and
- Mandates to prepare a number of studies in addition to writing almost 100 rules.

Finally, the *Jumpstart Our Business Startups (JOBS) Act of 2012* was enacted after a prolonged period of slow growth and high unemployment, and aims to ease the regulatory burden on smaller (job-creating) businesses seeking to raise capital. It includes, among other

[35] BCG Report, supra note 8.

[36] Most of these will be discussed in more detail below.

provisions, mandates for the SEC to write rules facilitating the offer and sale of securities through crowdfunding,[37] expanding certain exemptions from the '33 Act's registration requirements, loosening restrictions on "solicitations" of investments sold in private offerings, and permitting confidential submissions by emerging growth companies during the IPO process.[38]

2. SEC Organization and Relation to Other Regulatory Entities

a. Structure of the SEC

The SEC is divided into five divisions, 22 headquarters-based offices, and 11 regional offices.[39] Figure 1 provides a current SEC organization chart. There are three SEC divisions responsible for specific market segments and statutory regimes: Corporation Finance, Investment Management, and Trading & Markets. Two other divisions, Enforcement and Economic Risk Analysis, serve functions that cut across the entire regulatory purview of the SEC.

The Division of Corporation Finance is primarily focused on public company disclosures mandated under the '33 and '34 Acts. It selectively reviews filings made under these acts to ensure compliance with disclosure standards. There are approximately 9,000 reporting companies whose disclosures are monitored and reviewed by this division.[40]

The Division of Enforcement is responsible for the civil enforcement of the federal securities laws. It investigates potential violations and represents the Commission in its enforcement actions and lawsuits in federal courts or the SEC's own administrative courts. Penalties imposed may include injunctions, monetary penalties and disgorgement, and suspension from the securities industry or from acting as a corporate officer or director.[41]

---

37 Crowdfunding involves raising small sums money from a large number of people (usually via the internet). The JOBS Act would, among other things, exempt crowdfunding "portals" from registration requirements as broker-dealers.

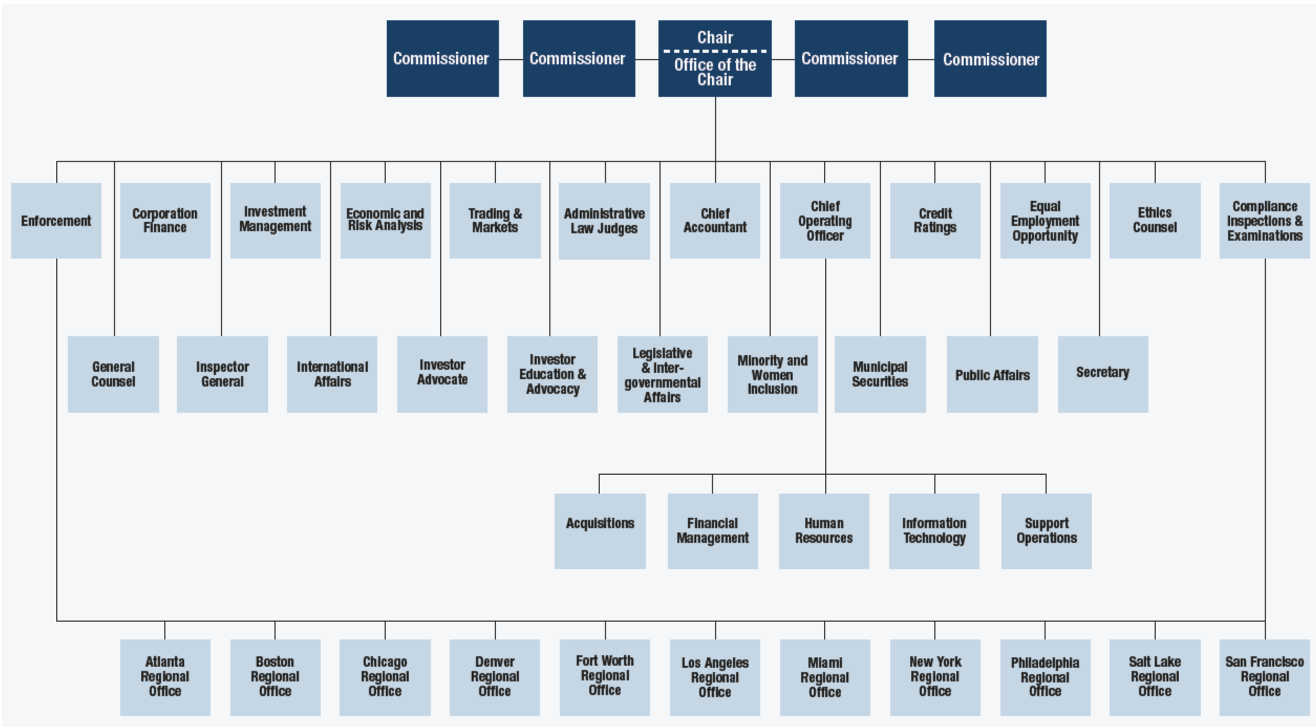
38 Confidential submissions are desirable to these companies, among other reasons, because the registration statement for an IPO contains large amounts of information, access to which could provide an advantage to these companies' rivals.

39 The regional offices consist almost entirely of personnel engaged in examinations and enforcement

40 CBJ 2015, supra note 1, at 4, 62.

41 *Id.* at 48. See below for a more discussion on enforcement.

Figure 1: SEC Organization Chart[42]



The Division of Investment Management regulates the asset management industry, monitoring compliance with the '40 Act and the Investment Advisers Act. The division reviews disclosures for relevant entities (e.g., investment companies) and products (e.g., variable insurance and annuities), serving a function similar to that of Corporation Finance for public companies. The division also issues guidance, drafts rule proposals, and monitors risk in the asset management industry. The division is responsible for overseeing approximately 11,000 investment advisers with $49.5 trillion in assets under management; and over 4,000 investment companies with $14.4 trillion in assets.[43]

The Division of Economic and Risk Analysis was established in 2009 "to integrate financial economics and rigorous data analytics into the core mission of the SEC."[44] The division has engaged in initiatives in support of the major offices and divisions in the SEC, including (among other things) providing extensive data and economic analysis in support of rulemaking efforts; creating "algorithms to analyze the order and transaction files of high-speed traders and quantify the extent of abusive trading" in several market manipulation investigations;

---

42 *Id.* at 11.

43 *Id.* at 80.

44 *About Division of Economic and Risk Analysis*, SEC website, http://www.sec.gov/dera/Article/about.html#.VCSS0xa6980

developing "a broker-dealer risk assessment program to help OCIE efficiently allocate its resources across more than 4,400 registrants by prioritizing inspections according to risk scores assigned to registrants"; creating and implementing an "aberrational performance inquiry model that has led to several enforcement actions against hedge fund managers"; and developing "the 'Accounting Quality Model,' … designed to identify risk factors associated with higher probabilities of earnings management and potentially nefarious behavior through managers' use of discretionary accruals."[45]

The Division of Trading and Markets oversees broker-dealers, in addition to the securities exchanges, self-regulatory organizations (SROs) such as the Financial Industry Regulatory Authority (FINRA), clearing agencies, and transfer agents. The division oversees approximately 4,450 broker-dealers, 450 transfer agents, 18 national securities exchanges, six securities futures exchanges, and seven registered clearing agencies.[46] It is also responsible for oversight of the new entities defined by Dodd-Frank Title VII, including security-based swap execution facilities, security-based swap data repositories, security-based swap dealers, and major security-based swap participants.[47] One of its chief functions, in addition to surveilling markets, engaging in rule-making, and issuing guidance, is to review and approve proposed new rules and rule changes submitted by SROs. In calendar year 2013, it reviewed on an expedited basis almost 2,700 such proposed rule changes.[48]

Several SEC "offices" are also worth highlighting. First and foremost, the *Office of Compliance, Inspections and Examinations (OCIE)*, which has more staff than any division except Enforcement, "administers the SEC's nationwide examination and inspection program for registered self-regulatory organizations, broker-dealers, transfer agents, clearing agencies, investment companies, and investment advisors."[49] Dodd-Frank created five new offices, including the *Office of Credit Ratings*, which supervises registered credit ratings agencies,[50] and the *Office of Municipal Securities*, which oversees approximately 1,000 municipal advisers, as well as the Municipal Securities Rulemaking Board (MSRB).[51]

---

[45] CBJ 2015, supra note 1, at 82.
[46] *Id.* at 4, 64.
[47] *Id.* at 66.
[48] *Id.* at 66.
[49] *The Investor's Advocate*, supra note 12; CBJ 2015, supra note 1, at 55.
[50] CBJ 2015, supra note 1, at 101.
[51] *Id.* at 104.

b. SEC Staffing and Budget

The SEC operated with a budget of approximately $1.416 billion for fiscal year 2014, and employs a staff of over 4,000.[52] Table 1 provides current and prospective employment figures, and Table 2 provides budget data.

The SEC has requested $1.722 billion for fiscal year 2015. Although the SEC's budget is determined by Congress, it is paid for by three types of transaction fees on the securities industry. First is a registration fee for new offerings, currently set at $128.80 per million dollars.[53] Second is a fee on all securities transactions, currently set at $22.10 per million dollars.[54] Third is an assessment on security futures transactions, currently set at $0.0042 for each round-turn transaction.[55]

---

52 U.S. Securities and Exchange Commission, FY 2016 Congressional Budget Justification, FY 2016 Annual Performance Plan, FY 2014 Annual Performance Report [hereinafter CBJ 2016], available at http://www.sec.gov/about/reports/secfy16congbudgjust.pdf.

53 Fee Rate Advisory #1 for Fiscal Year 2014, SEC Press Release, http://www.sec.gov/News/PressRelease/Detail/PressRelease/1370539795693#.VCR_qha6980

54 Fee Rate Advisory #3 for Fiscal Year 2014, SEC Press Release, http://www.sec.gov/News/PressRelease/Detail/PressRelease/1370540783933#.VCR_aRa6980

55 *Id*. A "round turn" includes "all transactions where an actual futures position is closed out or offset. This would include futures positions closed out by delivery, cash settlement, through an exchange for physicals, and as a result of the transfer to the carrying FCM from another FCM of offsetting futures contracts." *What is a Futures Contract Round-Turn?*, National Futures Association website, https://www.nfa.futures.org/NFA-faqs/nfa-assessment-fees_faqs/assessment-fees/what-is-a-futures-contract-round-turn.HTML

Table 1: Full-time Equivalents and Position by Program[56]

	Actual		Enacted		Request	
	FTE	Actual Positions	FTE	Budgeted Positions	FTE	Budgeted Positions
Enforcement	1,266	1,373	1,343	1,400	1,410	1,493
Compliance Inspections and Examinations	902	975	964	1,080	1,106	1,305
Corporation Finance	457	497	474	506	494	513
Trading and Markets	242	271	256	279	282	291
Investment Management	165	190	186	198	204	210
Economic and Risk Analysis	56	150	140	164	164	170
General Counsel	122	140	131	144	136	148
Other Program Offices						
Chief Accountant	31	47	45	48	49	51
Investor Education and Advocacy	42	45	41	46	45	50
International Affairs	46	54	50	55	57	58
Administrative Law Judges	10	14	14	14	14	15
Investor Advocate	2	6	5	8	7	9
Credit Ratings	32	44	41	47	49	51
Municipal Securities	4	8	7	9	9	10
Total	167	218	203	227	230	244
Agency Direction and Administrative Support						
Executive Staff	44	49	46	49	48	50
Public Affairs	9	11	10	12	12	13
Secretary	19	21	19	22	21	23
Chief Operating Officer	23	26	26	30	31	32
Financial Management	88	101	96	102	104	103
Information Technology	153	175	170	181	183	195
Human Resources	104	122	121	130	137	149
Acquisitions	48	59	58	59	59	59
Operations Support	90	104	102	105	106	110
Ethics Counsel	15	16	16	17	18	18
Minority and Women Inclusion	8	9	9	10	11	12
Equal Employment Opportunity	10	11	10	11	11	13
Total	611	704	683	728	742	777
Inspector General	25	34	36	48	47	54
Total FTE and Positions	4,150	4,663	4,460	4,818	4,859	5,249
Permanent	4,013	4,552	4,416	4,774	4,815	5,205
Temporary	137	111	44	44	44	44

56 CBJ 2016.

Table 2: SEC Budget: Obligations by Object Class[57]

(DOLLARS IN THOUSANDS)	FY 2014 Actual	FY 2015 Enacted	FY 2016 Request
Personnel Compensation & Benefits			
Total Personnel Compensation (11.9)	$ 681,000	$ 782,005	$ 880,936
Civilian Personnel Benefits (12.1)	219,788	236,381	270,695
Subtotal Cost of Salaries	**$ 900,788**	**$ 1,018,386**	**$ 1,151,631**
Other Expenses			
Benefits for Former Personnel (13.0)	1,826	1,738	1,766
Travel and Transportation of Persons (21.0)	11,292	13,501	14,148
Transportation of Things (22.0)	82	283	287
Rent, Communications & Utilities (23.0)[1]	108,827	113,947	115,986
Printing and Reproduction (24.0)	8,833	9,150	9,296
Other Contractual Services (25.0)	344,653	358,270	364,218
Supplies and Materials (26.0)	1,994	3,488	3,767
Equipment (31.0)	32,260	44,071	46,931
Building Alterations (32.0)	5,032	10,390	12,751
Claims and Indemnities (42.0)	227	1,200	1,219
Refunds (44.0)	—	—	—
Undistributed (92.0)	—	—	—
Subtotal Cost of Other Expenses	**$ 515,026**	**$ 556,038**	**$ 570,369**
Spending Authority	**$ 1,415,814**	**$ 1,574,424**	**$ 1,722,000**

c. Rulemaking Process and Constraints

The SEC drafts new rules pursuant to statutory mandates or, within the scope of its existing authority, at the direction of the SEC chair, in consultation with Division heads and other top agency officials. The rulemaking process generally begins with staff drafting a rule proposal.[58] Once the Commission approves the proposal by a majority vote, it becomes public and comments are solicited. The comment period typically extends for 30-60 days. A final rule is then drafted and adopted by a majority vote of the commissioners. In drafting the rules, the SEC must adhere to a number of process-focused statutes.

There are a number of statutes that constrain the rulemaking process. These are described in more detail in Part II, below. A quick summary is nevertheless in order: The Administrative Procedure Act of 1946 requires the agency to publicize proposed rules and seek comment on them prior to adoption. The Paperwork Reduction Act of 1980 requires the

---

57 CBJ 2016.

58 *Rulemaking,* SEC website, http://www.sec.gov/answers/rulemaking.htm. Sometimes the rule proposal is preceded by a concept release, typically if the rule or the problem it is trying to tackle is new, unique, and/or complicated.

commission to consider (and estimate) the burden any information collection provisions of a new rule will impose on members of the public, and makes any such provisions subject to OMB approval.[59] Under the Regulatory Flexibility Act of 1980, the agency must consider the impact its rules are likely to have on small businesses and other small organizations, and where the burden is determined to be significant, to seek less burdensome alternatives. Finally, as part of the National Securities Markets Improvement Act of 1996, Congress mandated that the SEC consider likely effects on efficiency, competition, and capital formation in its rule-making process.[60] This has been interpreted by the SEC as requiring a cost-benefit analysis for each rule, and courts have not been shy about striking down rules if they determine that the SEC's cost-benefit analysis was inadequate.[61]

d. Relationship with FSOC and Other Regulatory Entities

The SEC has memoranda of understanding (MOUs) to share information and cooperate across areas of common interest with a number of other regulators, such as the CFTC and the Federal Reserve.[62] Since the passage of Dodd-Frank, the SEC has also coordinated with other U.S. financial regulators on issues relating to systemic stability as a member of the Financial Stability Oversight Council (FSOC). The SEC Chair is a member of the FSOC, and participates in the Council meetings, which Dodd-Frank mandates must occur at least once a quarter.[63] Over the past two years the Council has met slightly less frequently than once every month.[64] A senior SEC official also participates in a bi-weekly Deputies Committee meeting, which "coordinate[s] and oversee[s] the work of the [Systemic Risk Committee] and five other functional committees."[65] SEC staff participate in the functional committees to the degree they touch on the markets, entities, or products the SEC oversees.

Also as a result of Dodd-Frank, the SEC has also been required to coordinate and consult with other agencies on a number of different rule-making efforts. Most saliently, the SEC has had to draft joint rules with the CFTC on certain derivatives-related issues, such as promulgating a consistent set of definitions for swap products (see below). For the Volcker Rule, the SEC had to coordinate with the Office of the Comptroller of the Currency, the Federal Reserve, the CFTC and the FDIC. While the regulators eventually agreed on a final, harmonized rule, the process took several years. (It was approved in December 2013 and became effective in April 2014.)

---

59 BCG Report, supra note 8.

60 Katz 2011, supra note 11, at 84.

61 For example, the DC Circuit struck down the Commission's proxy access rule on these grounds in 2011.

62 http://www.federalreserve.gov/newsevents/press/bcreg/20080707a.htm

63 Financial Stability Oversight Council 2014 Annual Report [hereinafter FSOC Annual Report], http://www.treasury.gov/initiatives/fsoc/Documents/FSOC%202014%20Annual%20Report.pdf.

64 FSOC meeting minutes, http://www.treasury.gov/initiatives/fsoc/council-meetings/Pages/meeting-minutes.aspx.

65 FSOC Annual Report, supra note 63, at 110.

Reports surfaced during this process that the extended delay was due to a rift between the SEC and the banking regulators.[66]

e. Congressional Oversight

Senate oversight of the SEC rests with the Senate Banking Committee, with special attention from the Subcommittee on Securities, Insurance and Investment.[67] House oversight powers are vested with the Committee on Financial Services, with the SEC a particular focus of the Subcommittee on Capital Markets and Government-Sponsored Enterprises. The key appropriations subcommittee in both chambers is the Subcommittee on Financial Services and General Government.

In addition to controlling the SEC's budget through the appropriations process, congressional committees periodically call the SEC chair and other top officials to testify. Since the beginning of 2013, the SEC chair has testified four times before the full Senate Banking Committee and three times before the full House Financial Services Committee.[68] She[69] has also testified before the House Subcommittee Committee on Capital Markets and Government-Sponsored Enterprises once; before the Senate Appropriations Subcommittee twice; and before the House Appropriations Subcommittee once.[70] Other officials called to testify before Congressional committees or subcommittees during this period include the Director of Corporation Finance (three times), the SEC's Inspector General (once), and the Director of Trading and Markets (twice).[71]

f. Relationship with Foreign and International Regulatory Bodies

The SEC has an Office of International Affairs to coordinate its cooperative efforts with foreign and international regulatory bodies.[72] The SEC has ten comprehensive memoranda of understanding (MOUs) with foreign securities regulators, "as well as number of more tailored arrangements. … Most recently, the SEC concluded 28 MOUs with European regulators related to cross-border asset management."[73] In FY 2013, the SEC made 717 requests for foreign

---

66 http://online.wsj.com/news/articles/SB10001424052970203400604578072824053423376.

67 The official name of the full committee is the "United States Senate Committee on Banking, Housing, and Urban Affairs."

68 Testimony, SEC website, http://www.sec.gov/News/Page/List/Page/1356125649559.

69 There have been two SEC chairs during this period: Elisse Walter and Mary Jo White.

70 Testimony, supra note 68.

71 *Id.*

72 CBJ 2015, supra note 1, at 95.

73 *Id.* at 97.

enforcement assistance; in turn, it responded to 580 requests from foreign regulators for enforcement assistance, and 416 requests for technical assistance.[74]

The SEC also plays an active role on the boards of the International Organization of Securities Commissions (IOSCO) and the Financial Stability Board (FSB). Current IOSCO priorities include "developing a toolbox of approaches to cross-border regulation; promoting best practices for effective deterrence of securities violations; assessments and thematic peer reviews of global implementation of selected IOSCO principles and standards; and coordination of efforts to identify globally systemically important non-bank financial institutions."[75] The FSB, meanwhile, is "a forum for collaboration on financial market and regulatory issues among international standard setters, international financial institutions, and various national financial, regulatory and supervisory authorities."[76] The FSB promotes regulatory cooperation and dialogue on issues relating to systemic risk. The SEC also participates in a series of bilateral dialogues with foreign counterparts, including the EU, Canada, Mexico, China, and India.[77]

Substituted compliance/mutual recognition. "Substituted compliance" or mutual recognition would permit foreign broker dealers, exchanges, and other entities to operate in U.S. markets without registering with the SEC and formally complying with SEC rules, if the SEC determined that the entity was subject to substantially comparable regulation by its home country regulator. Such an approach would likely hinge on reciprocal treatment of US entities operating in the foreign country. The benefits of such a system could include minimizing the various costs of redundant regulation and facilitating cross-border trade and competition. The SEC has a fairly comprehensive mutual recognition agreement with its Australian counterpart.[78] In 2008, just prior to the crisis, it took substantial steps towards negotiating mutual recognition agreements with Canada and the EU.[79] Those efforts stalled, presumably as the SEC's resources were diverted to deal with the crisis and subsequent reform efforts.

One area of SEC regulation where a system of substituted compliance *is* moving forward is in security-based swaps. In June 2014, the SEC (lagging the CFTC) issued a final rule on certain aspects of cross-border securities-based swap recognition,[80] which, among other things, defines the process by which market participants may request a "substituted compliance order"

---

[74] *Id.* at 98.
[75] *Id.* at 97.
[76] *Id.*
[77] *Id.* at 97-98.
[78] Mutual Recognition Arrangement between the United States Securities and Exchange Commission and the Australian Securities and Investments Commission, available at http://www.sec.gov/about/offices/oia/oia_mutual_recognition/australia/framework_arrangement.pdf.
[79] Schedule Announced for Completion of U.S.-Canadian Mutual Recognition Process Agreement, Press Release, http://www.sec.gov/news/press/2008/2008-98.htm; SEC Announces Next Steps for Implementation of Mutual Recognition Concept, Press Release, http://www.sec.gov/news/press/2008/2008-49.htm.
[80] Final Rule, Application of ``Security-Based Swap Dealer'' and ``Major Security-Based Swap Participant'' Definitions to Cross-Border Security-Based Swap Activities, http://www.gpo.gov/fdsys/pkg/FR-2014-08-12/html/R1-2014-15337.htm.

from the Commission upon the determination that the market participant satisfies the relevant "Title VII requirements by complying with comparable foreign rules as a substitute."[81] The substantive criteria for the SEC to make such determinations were not addressed in this final rule, but will be addressed in future rules.

B. How and What the SEC Regulates

1. Regulatory Tools

The SEC exercises its authority in a number of ways. It promulgates rules pursuant to the major securities statutes. It mandates and reviews disclosure by issuers and other market participants, and surveils markets. It has approval authority for rules amendments by self-regulatory organizations, including exchanges. The SEC often issues "no action" letters in response to specific inquiries about proposed actual (not hypothetical) transactions. These provide assurance to those requesting the letter that they are highly unlikely to face an enforcement action by the SEC as a result of carrying out their transaction. The letters are called no-action letters "because the key expression in a favorable response to an inquiry states that the staff 'will recommend *no action* to the Commission' if the transaction is carried out as stated in the letter."[82] It is important to note that no-action letters do not bar private parties from challenging a transaction if they have standing, and the letters' "predictive value [for future similar transactions] is seriously weakened by the power of the Commission or its staff to reconsider the position it took in [an] earlier no-action letter."[83] Finally, the SEC has extensive examination and enforcement authorities, discussed below.

a. National Examination Program

The SEC carries out examination of registered entities under the auspices of the National Examination Program (NEP), implemented by the OCIE's approximately 900 staff stationed throughout the SEC's 12 offices.[84] NEP consists of four program areas. The first programmatic area focuses on investment advisers and investment companies.[85] Because of the large number of these entities – approximately 11,000 investment advisers and 10,000 investment companies[86] – combined with the lack of a SRO to help examine OCIE staff, only 9 percent of investment advisers and 11 percent of investment companies were examined in FY 2013.[87]

---

81 *Id.*

82 Cox et al., supra note 16, at 12

83 *Id.*

84 CBJ 2015, supra note 1, at 55.

85 National Examination Program: Offices and Program Areas [hereinafter National Examination Program], SEC website, available at http://www.sec.gov/ocie/Article/about.html#.VE_vZslD0sl.

86 CBJ 2015, supra note 1, at 4.

87 *Id.* at 30.

The second program area (after investment advisers and investment companies) covers broker-dealers.[88] There are approximately 4,500 broker-dealers in the United States, but the SEC, in conjunction with FINRA, was able to examine almost half of them in FY 2013.[89] The third area, "market oversight," covers exchanges and self-regulatory organizations.[90] This includes national securities exchanges as well as SROs such as FINRA and the MSRB. It will also include security-based swap execution facilities once the SEC adopts final rules with respect to their registration.[91] Finally, the fourth area, "clearance and settlement," covers all clearing and transfer agents.[92] It will also include Security-based Swap Data Repositories (SDRs) once rules requiring their registration become effective.[93]

OCIE staff has three areas of focus in carrying out an examination of an entity:

i) Compliance with applicable federal securities laws and rules, as well as any relevant SRO rules;
ii) The accuracy of and adherence to disclosures made to clients, customers, the public, and the Commission; and
iii) The existence of adequate policies and systems reasonably designed to ensure continued compliance with relevant laws and rules.[94]

An entity may be selected for an examination for one of several reasons. First, there may be a statutory mandate for the SEC to review the entity on a periodic basis. The Dodd-Frank Act, for example, mandates that all systemically designated clearing agencies be examined annually by their primary supervisor. The systemically designated clearing agencies for which the SEC is the primary supervisor are the Depository Trust Company (DTC), the National Securities Clearing Corporation (NSCC), the Fixed Income Clearing Corporation (FICC), and the Options Clearing Corporation (OCC).[95] The SEC's other examinations are often (informally) categorized as "routine," "cause," or "sweep." Routine exams occur "according to a cycle that is based on a firm's perceived risk, and focus on industry areas that have been identified as posing

88 National Exam Program, supra note 85.

89 CBJ 2015, supra note 1, at 30.

90 National Exam Program, supra note 85.

91 Examination Priorities for 2014 at 9, National Exam Program, Office of Compliance, Inspections, and Examinations [hereinafter Examination Priorities], available at https://www.sec.gov/about/offices/ocie/national-examination-program-priorities-2014.pdf. (The SEC has proposed but not yet finalized this rule. See http://www.sec.gov/rules/proposed/2011/34-63825.pdf.)

92 National Exam Program, supra note 85.

93 Examination Priorities, supra note 91, at 16. (The SEC has proposed but not yet finalized this rule. See http://www.sec.gov/rules/proposed/2010/34-63347.pdf.)

94 CBJ 2015, supra note 1, at 55; *Examination Information for Entities Subject to Examination or Inspection by the Commission* [hereinafter Examination Information], available at http://www.sec.gov/about/offices/ocie/ocie_exambrochure.pdf.

95 Examination Priorities, supra note 91, at 10.

the greatest compliance risks generally."[96] In order to assess its risk-based selection process, the SEC will also select some firms at random for examination.[97] "Cause" examinations arise from tips, complaints, or referrals.[98] "Sweep" examinations arise out of concerns about industry-wide risks rather than firm-specific risks: "[a]lso known as 'theme' examinations, sweep examinations gather discrete information about the extent, scope and danger of emerging risks across an industry."[99]

The OCIE does not typically reveal the reason an entity has been selected for an examination.[100] Examination can occur on an announced or unannounced basis.[101] In many but not all examinations, OCIE staff will visit the physical premises of the examinee.[102] The examination itself typically begins with an initial interview with the firm's senior management. If the examination is on-site, examiners will typically tour the premises in order "to gain an overall understanding of the entity's organization, flow of work, and control environment."[103] The examination will then largely consist of a review of documents requested by the examiners and produced by the entity, as well as documents requested (on a voluntary basis) from third parties dealing with the entity, and targeted interviews and meetings with entity employees.

Within 180 days of the latter occurrence of (a) completing the on-site visit and (b) receiving all records requested from the entity, the SEC is required to "provide the entity being examined or inspected with written notification indicating either that the examination or inspection has concluded, [that it] has concluded without findings, or that the staff requests the entity [to] undertake corrective action."[104] Staff typically fulfills this requirement by sending the entity a "deficiency letter" within the 180-day window. The entity is given 30 days to respond to the letter, laying out the steps it has taken or will take to address the issues identified in the deficiency letter.[105] OCIE will then either respond to the entity's comments within 60 days (which could require a further response from the entity) or, if satisfied with the response, close the examination.[106] The OCIE tracks the percentage of firms receiving deficiency letters that agree to take corrective reaction in response to all exam findings: this figure has hovered around

---

96 Derek M. Meisner, *A Primer for Investment Advisers, Companies in Mass. And Beyond,* available at http://www.klgates.com/files/tbl_s48News/PDFUpload307/11620/Meisner%20article.pdf.

97 Examination Information, supra note 94, at 1.

98 *Id.*

99 Meisner, supra note 96.

100 Examination Information, supra note 94, at 1.

101 *Id.* at 2. Unannounced, or "surprise," exams will often be cause exams, arising from a tip, complaint, or referral.

102 *Id.*

103 *Id.*

104 Section 4E(b)(1) of the Securities Exchange Act of 1934. This requirement was added by Dodd-Frank § 929U as an amendment to the '34 Act.

105 Examination Information, supra note 94, at 4.

106 *Id.*

90 percent for the past six years.[107] There are a limited number of "corrective action reviews" to verify that corrective steps promised by the entity are, in fact, taken.[108] If examiners believe there is a persistent or potentially serious violation of the securities laws at the entity, they will refer the issue to the Division of Enforcement.

b. Enforcement

The SEC devotes more resources to enforcement than to any other activity. The Division of Enforcement is the SEC's largest division, and has more than 1,200 staff spread through the 12 SEC offices.[109] The division is responsible for investigating potential securities law violations, recommending that the Commission bring civil actions, and prosecuting cases in federal court or administrative proceedings.[110] Typical misconduct that the division investigates includes making material misrepresentations about securities; manipulating market prices of securities; insider trading; stealing customer funds or securities; and selling unregistered securities.[111] Information leading to an enforcement investigation may come from general market surveillance activities, referrals from other SEC units or self-regulatory organizations such as FINRA, tips or complaints from investors or other market actors, or news reports.[112] SEC investigations are nonpublic; if division staff believe a civil action is warranted, it will present its findings with a recommendation to the Commissioners, who must vote on whether to proceed.

Often the parties will settle before trial. If the case goes to trial, the Commission has two options. First, it can file a complaint with a federal district court and seek one of several sanctions or remedies. It may seek an injunction against certain misconduct, which may include "special supervisory arrangements."[113] It may seek to bar an individual from the securities industry or from serving as a corporate officer or director.[114] Finally, it can seek monetary penalties and the disgorgement of ill-gotten gains.[115] Second, the Commission can seek to bring the case in front of an administrative law judge (ALJ), who is appointed by but independent from the Commission. The ALJ will issue an "initial decision" that the Commission (i.e., the Commissioners) may then affirm, reverse, or remand for further proceedings.[116] Sanctions an ALJ may impose include "cease and desist orders, suspension or revocation of broker-dealer and investment advisor registrations, censures, bars from association with the securities industry,

---

107 CBJ 2015, supra note 1, at 30.
108 *Id.*
109 *Id.* at 48.
110 *The Investors Advocate*, supra note 12.
111 *Id.*
112 *Id.*
113 *Id.*
114 *Id.*
115 *Id.*
116 *Id.*

civil monetary penalties, and disgorgement."[117] Whether to pursue a case in court or in administrative proceedings is typically a discretionary decision by the SEC. The SEC has recently been pursuing an increasing number of cases in administrative proceedings (where some perceive it to have a "home court advantage") since Dodd-Frank authorized it to seek penalties against *any* defendant in such proceedings; prior to Dodd-Frank, "only those subject to the S.E.C.'s direct regulation, such as brokers and investment advisers, could be required to pay a penalty by an administrative judge."[118]

In the fiscal year that ended in September 2014, the SEC filed 755 enforcement actions and obtained orders totaling $4.16 billion in disgorgement and penalties, both records.[119] The Division highlighted areas of enforcement including combating fraud and enhancing issuer disclosure; ensuring exchanges, traders, and other market participants operate fairly; uncovering misconduct by investment advisers and investment companies; pursuing gatekeepers such as accountants and attorneys for wrongdoing; rooting out insider trading; upholding disclosure standards in municipal securities; pursuing misconduct among sponsors of mortgage-backed securities and collateralized debt obligations; and demanding admissions of wrongdoing in certain categories of cases.[120]

The division's (new) whistleblower office is also proving to be a powerful (if slightly unwieldy) tool of enforcement, taking in thousands of tips per year, but leading to several recent enforcement actions. The program incentivizes whistleblowing by providing that any person providing new information that leads to monetary sanctions for a violation of securities laws of $1 million or greater may receive an award equal to 10-30% of the total moneys collected.[121] In FY 2014, nine individuals received a total of $35 million in awards through the whistleblower program.[122]

2. Markets, Entities, Products, and Activities

The SEC is the primary regulator of the nation's securities markets. The most common types of securities are equities and fixed-income securities (stocks and bonds). As of the end of

---

117 *Id.*

118 Peter J. Henning, *The SEC's Use of the 'Rocket Docket' Is Challenged*, NY Times Dealbook, Aug. 25, 2014, http://dealbook.nytimes.com/2014/08/25/the-s-e-c-s-use-of-the-rocket-docket-is-challenged/?_r=1.

119 *SEC's FY 2014 Enforcement Actions Span Securities Industry and Include First-Ever Cases* [hereinafter 2014 Enforcement Press Release], SEC Press Release 2014-230, http://www.sec.gov/News/PressRelease/Detail/PressRelease/1370543184660#.VFKXZRY8Sm1.

120 *Id.* "Staff considers requiring admissions in cases where the violation of the securities laws includes particularly egregious conduct, where large numbers of investors were harmed, where the markets or investors were placed at significant risk, where the conduct obstructs the Commission's investigation, where an admission can send a particularly important message to the markets, or where the wrongdoer poses a particular future threat to investors or the markets." *Id.*

121 CBJ 2015, supra note 1, at 49.

122 2014 Enforcement Press Release, supra note 119.

October 2014, the total U.S. stock market capitalization was estimated to be $24.25 trillion.[123] The average daily trading in U.S. equities in October 2014 was $327.6 billion.[124]

The bond markets are similarly vast. At the end of the second quarter of 2014, the total value of bonds outstanding included:

- $3.7 trillion in municipal bonds;
- $12.1 trillion in Treasury bonds;
- $8.7 trillion in mortgage-related bonds;
- $7.7 trillion in corporate bonds;
- $2 trillion in U.S. agency securities (e.g., Fannie Mae);
- $1.4 trillion in asset-backed securities.[125]

While most equities trade on exchanges, the majority of other securities are traded over the counter by "market makers," primarily "bank-affiliated broker-dealers."[126] Market makers are responsible for "the majority of trading in government, municipal, and corporate bonds; over-the-counter derivatives; currencies; commodities; mortgage-related securities; and large blocks of equities."[127] Market makers maintain "an inventory of particular securities and publish[] quotes with respect to the prices at which [they are] willing to buy (the bid price) and sell (the asked price)."[128]

a. Exchanges and Alternative Trading Systems

Securities exchanges provide a public market for buyers and sellers of securities to match their orders. As recently as a decade ago, two exchanges, NASDAQ and the New York Stock Exchange, dominated US equities trading; today, trading is much more widely dispersed.[129] Today, there are 18 national securities exchanges registered with the SEC to trade equity securities, and six other exchanges registered for the purposes of trading security futures.[130] Exchanges are self-regulatory organizations with obligations to set rules of conduct, trading rules, and listing standards, and to establish disciplinary mechanisms for members who violate their rules. In addition to the exchanges, securities may trade on more than 40 "alternative

---

123 Dow Jones U.S. Total Stock Market Index, http://www.djindexes.com/mdsidx/downloads/fact_info/Dow_Jones_US_Total_Stock_Market_Index_Fact_Sheet.pdf.

124 BATS Market Volume Summary, http://www.batstrading.com/market_summary/.

125 SIFMA Statistics, http://www.sifma.org/research/statistics.aspx (click on US bond market issuance and outstanding).

126 Darrell Duffie, Market Making Under the Proposed Volcker Rule, available at http://www.darrellduffie.com/uploads/policy/duffievolckerrule.pdf.

127 *Id.*

128 Cox et al., supra note 16, at 106.

129 Jacob Bunge, *A Suspect Emerges in Stock Trade Hiccups: Regulation NMS*, Wall Street Journal, Jan. 27, 2014, http://online.wsj.com/news/articles/SB10001424052702303281504579219962494432336.

130 *Exchanges*, SEC website, http://www.sec.gov/divisions/marketreg/mrexchanges.shtml.

trading systems" (ATS) or through 250 different broker dealers.[131] ATSs are trading markets that match and execute orders of multiple buyers and sellers using "established non-discretionary methods," but that have been exempted from registration as exchanges by the SEC under Regulation ATS (Reg ATS).[132]

Unlike exchanges, ATSs do not have to have their "own rules for professional conduct, trading rules, and fee structure for access to [their] facilities."[133] They *do*, however, have to register with the SEC as broker-dealers and to become members of FINRA. Furthermore, ATSs that trade more than 5 percent of any security must establish a link to an established exchange, in order to ensure that the ATS's price will be part of the public quote stream.[134] And if an ATS surpasses the 20 percent threshold for total trading volume in a given security, it will "be subject to additional regulation, such as a requirement of nondiscrimination in access and ensuring that [it] build into [its] systems mechanisms for guaranteeing adequate systems capacity, integrity, and contingency planning."[135] Some ATSs are "lit," meaning their bid or ask quotations are publicly displayed, while some are "dark," meaning that the venue does not post prices prior to execution. These "dark pools" are sometimes seen as useful venues for buyers or sellers of large blocks, who hope to avoid moving the market price before their order is fully executed.

Traditionally, exchanges in the U.S. were non-profit and owned by their members; over the past 15 years, however, all the major exchanges have "demutualized and are now themselves publicly traded, for-profit companies."[136] Further, at the turn of the millennium, "the majority of equity share volume was executed manually on exchange floors or over the telephone."[137] Today, virtually all equity trading is done electronically.[138] Largely as a result of the transition to electronic trading, markets have seen the rise of Straight Through Processing (STP), which entirely eliminates any manual intervention in the trading process.[139] As a recent study of the SEC's organizational challenges explains,

> When fully implemented, STP provides market participants with faster trade settlements, reduced settlement risk, and lower operating costs. STP is a critical enabler of high-

---

131 Mary Jo White, *Enhancing Our Equity Market Structure,* speech delivered at Sandler O'Neill & Partners, L.P. Global Exchange and Broker Conference, June 5, 2014 [hereinafter White Speech], http://www.sec.gov/News/Speech/Detail/Speech/1370542004312#.VFJvQxY8Tcg.

132 Cox et al., supra note 16, at 1015.

133 *Id.*

134 *Id.*

135 *Id.*

136 Cox et al., supra note 16, at 96.

137 BCG Report, supra note 8, at 29.

138 *Id.*

139 *Id.*

> frequency trading and other high-volume strategies: without it, back offices would struggle to support the volume of trades generated.[140]

The technological advances in trading combined with regulatory changes have intensified competition and propelled the expanding number of trading venues. On the regulatory side, Regulation National Market System (Reg NMS), among other key provisions, adopted the "Order Protection Rule," which prohibits "trade-throughs" by any trading center.[141] "A trade-through occurs," as the rule defines it, "when one trading center executes an order at a price that is inferior to the price of a protected quotation, often representing an investor limit order,"[142] displayed by an(other) exchange.[143] Prior to the this rule, if the NYSE (for example)

> received an order to buy shares of XYZ Company, at a time when some electronic exchange was offering to sell XYZ shares for less than the NYSE's 'offer' price[, i]nstead of shipping the order to that electronic exchange for immediate execution, NYSE floor traders were allowed to adjust their own offer price, and fill the trade. It was as if the electronic exchange had a yield sign that let floor traders pass first. … Reg NMS removed the yield sign. It required exchanges and brokers to immediately 'hit,' or accept, the most competitive bid or offer prices posted at any U.S. trading venue that displays price quotes. It sped up the stock market.[144]

An important point is that while the Order Protection Rule applies to all "trading centers," including market makers and ATSs, only quotes on exchanges are "protected."[145] This creates an incentive for entities that might otherwise register as ATS/broker-dealers to take on the added responsibilities of registering as a full-fledged exchange, and to fight for order flow in

---

140 *Id.*

141 Trading centers include "national securities exchanges, exchange specialists, ATSs, OTC market makers, and bock positioners." Final Rule, Reg NMS, [hereinafter Reg NMS Rule] http://www.sec.gov/rules/final/34-51808.pdf. An "OTC market maker" is "a dealer that holds itself out as willing to buy and sell the stock, otherwise than on a national securities exchange, in amounts of less than [10,000 shares]. A block positioner in a stock, in contrast, limits its activity in the stock to transactions of 10,000 shares or greater." *Id.*

142 A limit order is one of two basic types of order to purchase or sell stock. A market order directs a broker to fill an order for a particular share at whatever the (best) market price is. A limit order directs a broker to fill an order only if the security's price crosses a particular threshold (lower than the current price for buy orders and higher than the current price for sell orders). There are many variations on these basic order types, and algorithmic trading, along with competition for order flow among exchanges, has led to an explosion in order types, based on myriad conditions. For a controversial example, see Scott Patterson and Jenny Strasburg, *For Superfast Stock Traders, a Way to Jump Ahead in Line*, Wall St. J., Sept. 19, 2012, http://online.wsj.com/articles/SB10000872396390443989204577599243693561670 (describing a complicated order type called "hide not slide").

143 Reg NMS Rule, supra note 141.

144 Bunge, supra note 129. The motivation for the rule was that the "yield sign" "worried some regulators because they feared that floor-oriented markets were holding investors back from getting the best price instantly. Immediacy is a concern in a world where prices are constantly changing as trades take place and new orders are placed or canceled." *Id.*

145 A "[p]rotected bid or protected offer means a quotation in an NMS stock that … (iii) [i]s an automated quotation that is the best bid or best offer of a national securities exchange, the best bid or best offer of The Nasdaq Stock Market Inc., or the best bid or best offer of a national securities association other than the best bid or best offer of The Nasdaq Stock Market Inc." Reg NMS Rule, supra note 141, at 481-482. "A 'national securities association' is an association of brokers and dealers registered as such under Section 15A of the Exchange Act [15 U.S.C. 78o–3]. The Financial Industry Regulatory Authority (''FINRA'') is the only national securities association registered with the Commission under Section 15A of the Exchange Act. FINRA does not list equity securities." http://www.gpo.gov/fdsys/pkg/FR-2012-06-27/pdf/2012-15408.pdf (f.n. 8).

order to increase their chances of displaying the best price (and winning the commission for executing the transaction). (Other venues, of course, are able to compete as ATSs by offering lowering trading prices or opacity for block traders, as with dark pools.) In order to attract order flow, exchanges will offer various rebates to brokers,[146] as well as catering to the increasingly exotic order-types demanded by the high-frequency trading firms that have become prevalent in the market. The need for brokers and traders to keep track of (and program their algorithms to account for) all the different order types and rebate policies among all the different exchanges has significantly increased the complexity of – and the risk of technical glitches in – equity trading markets. This point is discussed further under "Regulatory Challenges," below.

b. Broker-Dealers

The '34 Act provides the SEC with regulatory authority over broker-dealers, and the SEC shares oversight responsibilities with FINRA, a self-regulatory organization of which virtually all broker-dealers are members. Section 3(a)(4) of the '34 Act defines a broker as a person or entity "engaged in the business of effecting transactions in securities for the accounts of others," and Section 3(a)(5) defines a dealer as a person or entity "engaged in the business of buying and selling securities for his own account."[147] Most major firms engaged in brokering and dealing do *both*, and are routinely referred to as "broker-dealers."

The era of major Wall Street broker-dealers that were *not* part of a bank holding company ended in 2008 with the financial crisis. Of the five major "stand-alone" broker-dealers, one (Lehman Brothers) failed; two (Bear Stearns and Merrill Lynch) were sold to bank holding companies[148] (JP Morgan and Bank of America, respectively); and two (Goldman Sachs and Morgan Stanley) converted into bank holding companies. This is significant because as bank holding companies, these firms are subject to regulation by the Federal Reserve; and as bank holding companies with more than $50 billion in assets, they are subject to heightened supervision and regulatory requirements, including heightened consolidated capital requirements. Large broker-dealer subsidiaries of bank holding companies include the most recognized names on Wall Street, such as Goldman Sachs, Morgan Stanley, JP Morgan, Citigroup, Merrill Lynch (now integrated into Bank of America, but retaining its name for branding purposes), Deutschebank, UBS, and Barclays.

The SEC retains jurisdiction over the broker-dealer subsidiaries of bank holding companies, as well as all broker-dealers that are not part of bank holding companies. Much SEC regulation focuses on investor protection: for example, limits on margin loans for brokerage

---

146 Rebates provided by exchanges to brokers raise obvious conflict-of-interest problems between brokers and their customers. Rather than prohibiting the practice, the SEC has mandated disclosure. *See* Cox et al., supra note 16, at 1014.

147 Securities Exchange Act §3(a)

148 Only a particular type of bank holding company, namely a "financial holding company," may affiliate with broker dealers. The deposit-taking subsidiaries of a *financial* holding company must maintain good scores in their composite and management-specific "CAMELS" ratings, and meet slightly heightened capital standards.

customers; disclosure obligations to customers and clients as to potential conflicts of interest; limits on excessive trading of customer accounts, or churning, in order to generate fees;[149] obligations to recommend "suitable" securities for customers based on their investment objectives; and regulation of "boiler rooms," where broker-dealers intensively hawk a small number of securities to customers.[150]

While prudential regulation of broker-dealers pales in comparison to banks, the SEC does employ several tools focused on broker-dealer solvency, and on limiting the fall-out in the event of a failure. First, "broker-dealers must keep extensive records and file so-called FOCUS reports on their financial condition."[151] This, combined with the examination process, serves (in theory) as an early warning system of broker-dealer vulnerability. Second, broker-dealers face strict requirements relating to the segregation of customer accounts.[152] Third, the SEC oversees SIPC, which insures customer brokerage accounts against loss (of securities) or theft (though not against declines in value due to market movements).[153] Finally, broker-dealers must comply with the SEC's net capital rule, which serves as a (very) rough analog to capital requirements for banks.

c. Asset Management Industry

Asset management – that is, advising or making investment decisions on behalf of clients, customers, or investors – is done in the United States primarily by banks, insurance companies, and "dedicated asset management companies."[154] The lattermost are typically regulated by the SEC in one of two ways: (i) some types of funds must be registered as investment companies under the Investment Company Act of 1940; and (ii) the asset management company itself, and those making decisions for particular funds, must typically be registered as investment advisers under the Investment Advisers Act of 1940.[155]

The industry is highly concentrated: at the end of 2012, the top five mutual fund complexes managed almost half of all U.S. mutual fund assets, and the top 25 mutual fund complexes managed almost three-quarters of US mutual fund assets.[156] Table 3 provides a list of the top 20 asset managers.

---

149 One of the key persistent differences between brokers and investment advisers is that brokers tend to earn fees on a per-transaction basis, whereas investment advisers earn fees based on assets under management.

150 Carnell, supra note 2

151 Cox et al., supra note 16, at 1070.

152 *Id.* at 1072.

153 *Id.*

154 *Asset Management and Financial Stability* at 27 [hereinafter Asset Management Study], Office of Financial Research, Department of the Treasury, September 2013, http://www.treasury.gov/initiatives/ofr/research/Documents/OFR_AMFS_FINAL.pdf.

155 *Id.*

156 *Id.* at 3.

Table 3: Top 20 Asset Managers by Assets Under Management (as of 12/31/2013)[157]

		Assets Under Management, $ millions 12/31/2013
1	BlackRock	3,925,893.75
2	Vanguard Asset Management	2,497,393.75
3	State Street Global Advisors	2,127,063.75
4	Fidelity Investments	1,764,062.50
5	BNY Mellon Investment Management	1,437,347.50
6	J.P. Morgan Asset Management	1,412,317.50
7	PIMCO	1,396,230.00
8	Deutsche Asset & Wealth Management	1,163,750.00
9	Capital Group	1,134,886.25
10	Pramerica Investment Management	1,005,760.00
11	Amundi	971,388.75
12	Northern Trust Asset Management	802,352.50
13	Franklin Templeton Investments	798,926.25
14	Natixis Global Asset Management	786,500.00
15	Wellington Management Company	756,920.00
16	Goldman Sachs Asset Management International	732,632.50
17	Invesco	706,603.75
18	AXA Investment Managers	683,377.50
19	Legal & General Investment Management	675,422.50
20	T.Rowe Price	628,107.50

In addition to registered investment companies, described in more detail below, large asset managers also typically invest money on behalf of investors in "separate accounts." With a separate account, the asset manager "selects assets on behalf of large institutional investors or high net-worth individuals under mandates defined in an investment management agreement."[158] Table 4, below, provides a sense of the different products offered by top asset managers.

157 Source: Investment & Pensions Europe, Top 400 Asset Managers 2014, http://www.ipe.com/reports/top-400-asset-managers/. Figures were reported in euros; they were converted to dollars for this memo at an exchange rate of $1.25 to €1.00 (the rate in early November 2014).

158 *Id.* at 28. "Clients retain direct and sole ownership of assets under management. Separate accounts are not specifically regulated under the 1940 Act, the Securities Act of 1933, or bank-specific regulations, although managers of those accounts are often registered investment advisers required to register with the SEC or a state securities regulator." *Id.*

Table 4: Significant Asset Class Business Lines of Large Asset Managers (as of 12/31/12)[159]

Asset Managers	Alternatives	Equity	Fixed Income	Money Market Mutual Funds	Exchange Traded Funds	Collective Investment Trusts	Separate Accounts
BlackRock Inc.	x	x	x	x	x	x	x
BNY Mellon Asset Management	x	x	x	x		x	x
Capital Research & Management Company	o	x	x				o
Fidelity Investments		x	x	x		x	x
Franklin Templeton Investments		x	x				x
Goldman Sachs Asset Management	x	x	x	x			x
Invesco	x	x	x	x	x	x	x
J.P. Morgan Asset Management	x	x	x	x		x	x
Legg Mason Capital Management		x	x	x			x
Metlife Inc.	x		x			o	x
Northern Trust Global Investments	o	x	x	x		x	x
PIMCO	x		x				x
Prudential Asset Management		x	x				x
State Street Global Advisors		x	x	x	x	x	x
The Vanguard Group	o	x	x	x	x		o
Wellington Management	o	x	x				x

Note: This table is based on U.S.-domiciled markets; all asset managers listed except for Wellington Management manage money market funds; according to Morningstar, PIMCO had $9.1 billion under management in ETFs at the end of 2012.
x - signifies that AUM for a particular category was either greater than or equal to $50 billion.
o - signifies incomplete information.

d. Investment Companies

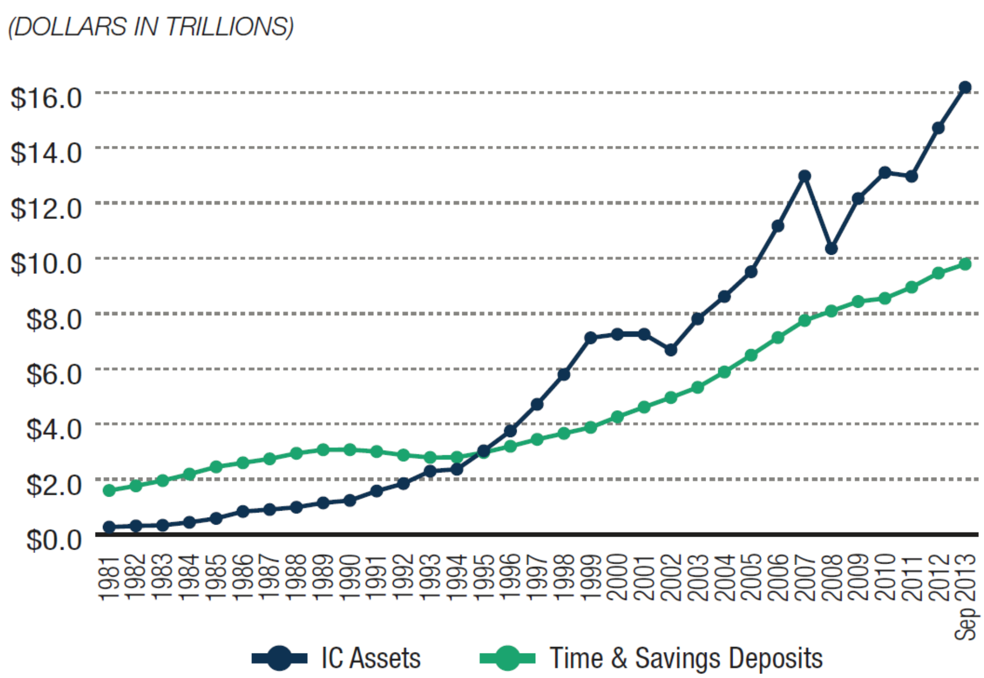
In broad terms, an investment company issues securities to investors, and is itself engaged primarily in the business of *investing* in securities. The SEC regulates investment

159 Asset Management Study, supra note 154, at 8.

companies under the Investment Company Act of 1940.[160] The '40 Act, among other provisions, prescribes strict limitations on investment companies' use of leverage and transactions with affiliates; prescribes strict standards for the custody of fund assets; and requires extensive disclosures relating, for example, to investment objectives, risks, and expenses.

Over the past three decades, the value of investment company assets has grown from a small fraction of the value of U.S. bank deposits to become significantly larger than it. Figure 2 compares investment company assets to deposits from 1981-2013.

Figure 2: Comparison of Investment Company Assets to Time and Savings Deposits[161]



While there are approximately 10,000 investment companies (mostly open-end (mutual) funds and exchange-traded funds), few are stand-alone; rather they are sponsored and managed by one of approximately 800 investment company complexes (of which the firms listed in Tables 3 and 4 are the largest).[162]

---

160 http://www.sec.gov/about/laws/ica40.pdf. Investment companies are, of course, subject to other securities laws: it must register the securities it sells under the '33 Act; and the purchase and sale of company shares must comply with antifraud provisions of the '34 Act.

161 CBJ 2015, supra note 1, at 74.

162 *Id.* at 55-56.

One way asset managers market investment companies is by the type of portfolio investments they make. Thus investment companies are sometimes categorized as index funds, stock funds, bond funds, hybrid funds, and money market funds.[163]

An *index fund* will try to mirror the returns of a broad-based market index, such as the S&P 500, and attempts "to achieve its investment objective primarily by investing in the securities (stocks or bonds) of companies that are included in a selected index."[164] Management of index funds tends to be more passive, with lower fees, than other types of managed funds.

Stock funds invest in stocks, and will usually provide information in the prospectus about what type of stocks the fund will target. An index fund may be a *stock* index fund; other types of stock funds focus, for example, on blue-chip stocks that pay regular dividends, or high-growth tech stocks that tend not to pay dividends.[165] *Bond funds*, meanwhile, invest in fixed-income securities, usually aiming at a particular type, such as government bonds, municipal bonds, corporate bonds, and so on.[166] *Hybrid funds* adopt a combination of the above investment strategies. *Money market funds* invest in money market instruments – that is, short-term debt with extremely low credit risk – and are discussed in more detail below.

Legally, there are three basic rubrics for investment funds: open-end (mutual) funds, closed-end funds, and unit investment trusts (UITs).[167] An open-end fund's shares are *not* bought and sold on secondary markets; rather, shares are bought ("redeemed") and sold continuously by the fund itself (though a fund may stop selling shares if it reaches a predetermined cap). The sale and purchase price of any shares are determined by the per-share value, after fees, of the fund's portfolio of assets minus its liabilities – i.e., its net asset value (NAV). Open-end funds comprise the vast majority of investment company assets.[168]

Closed-end funds differ from open-end funds primarily in that the shares are issued all at once (in an initial public offering) rather than on a continuous basis; and the shares are *not* redeemable by the fund itself, but *are* traded on secondary markets after issuance.[169] The shares

---

163 *Investment Companies,* supra note 167.

164 *Index Funds*, SEC website, http://www.sec.gov/answers/indexf.htm. "Some index funds may also use derivatives (such as options or futures) to help achieve their investment objective. Some index funds invest in all of the companies included in an index; other index funds invest in a representative sample of the companies included in an index." *Id.*

165 *Stock funds,* SEC website, http://www.sec.gov/answers/mfstock.htm.

166 *Bond Funds or Income Funds*, SEC website, http://www.sec.gov/answers/bondfunds.htm.

167 *Investment Companies*, SEC website, http://www.sec.gov/answers/mfinvco.htm.

168 As of Sept. 2013, they held $14.3 trillion of the $16.2 trillion total held by investment companies.

169 *Closed-End Fund Information*, SEC website, http://www.sec.gov/answers/mfclose.htm.

trade at a market-determined price.[170] Because the fund does not have the same obligation to redeem shares as an open-end fund, its portfolio can hold more illiquid assets.[171]

Unit investment trusts combine features of the closed-end and open-end funds, while differing from both in important ways. They typically issue shares in a one-time public offering, and the shares can often be traded on a secondary market (like a closed-end fund), but the issuer also stands ready to redeem shares from investors (like an open-end fund).[172] A few exchange-traded funds (ETFs) are structured as UITs; it should be noted that ETF shares can only be redeemed in large blocks (e.g., 50,000 shares).[173] (See below for more on ETFs.) UITs also tend to have (a) fixed durations, and (b) fixed portfolios.[174] They thus typically do not employ directors, officers, or investment advisers.

It is worth highlighting two special types of investment companies that are usually organized as open end funds.[175] One important type of open-end fund is the money market fund (MMF). MMFs developed in the 1970s as an alternative to bank accounts, as interest rates rose throughout the economy, but there was a cap on the interest banks were allowed to pay on deposits.[176] MMFs began investing in Treasury bills,[177] and because the interest on government debt was much higher than the maximum interest on deposits banks were allowed to pay, the MMFs' "shareholders" benefited from a higher return on their holdings (vis-à-vis bank accounts), while retaining many of the same attractive benefits of a bank account. These benefits included an extremely high degree of liquidity (MMF shares are redeemable on demand) and price stability (MMF shares have traditionally maintained a fixed NAV of $1.00 per share[178]). MMFs also often offer check-writing privileges to account holders. The run risk posed by MMFs is greater than other investment companies because the shares are redeemable on demand, and the use of amortized cost accounting[179] can create slight discrepancies between the official

---

170 It is thus possible that a closed-end fund's shares will trade slightly below or above the per-share NAV. Arbitrageurs tend to keep the discrepancy from growing large. If the market value of the portfolio rises above the official NAV of the fund, the arbitrageurs will buy the fund shares and sell (or short) the underlying securities, until the two prices match. (If the market value of the portfolio falls, the arbitrageurs will, of course, sell (or short) the fund shares and buy the underlying securities to effect the same result.)

171 *Closed-End Fund Information*, supra note 169.

172 *Unit Investment Trusts*, SEC website, http://www.sec.gov/answers/uit.htm.

173 *Id.*

174 *Id.*

175 A few ETFs are organized as UITs rather than open-end funds.

176 The maximum interest banks were allowed to pay on deposits was fixed by Regulation Q; the provision capping interest payments was abolished in 1986.

177 While the first MMFs invested in U.S. Treasury debt, they soon began investing in very high-quality, short-term debt issued by private companies and other governmental issuers, as well.

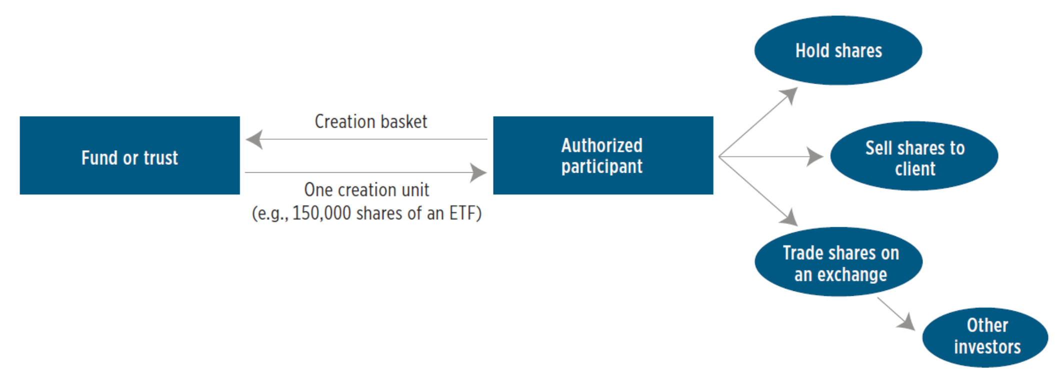
178 See discussion infra for recent MMF reforms requiring *some* MMFs ("institutional prime") to report floating NAVs.

179 Amortized cost accounting values portfolio securities at "as adjusted for amortization of premium, or accretion of discount, rather than at their value based on current market factors. Under the amortized cost method, portfolio securities generally are valued at cost plus any amortization of premium or accumulation of discount. The basic premise underlying MMFs' use of the amortized cost method is that high-quality, short-term debt securities held until maturity eventually will return to their amortized cost value, regardless of any current disparity between the amortized cost value and market value, and would not ordinarily be expected to fluctuate significantly in value. Thus, the rule permits these funds to be

NAV of the fund and the market value of the fund's underlying portfolio; shareholders who expect the NAV never to fall below $1.00 per share, then, have an incentive to run if a shock creates a fear of the fund's NAV dipping below $1.00 (and thus "breaking the buck").[180] Because of this vulnerability, MMFs face greater restrictions in terms of the credit quality (higher) and maturity (shorter) of what they are allowed to invest in compared to other investment companies.[181] MMFs account for over $2.6 trillion in total assets.

A final type of investment company worth highlighting is the exchange-traded fund (ETF).[182] Like a closed-end fund, the ETF's shares can be traded throughout the day at a market-determined price; but like an open-end fund, ETF shares can be created and redeemed on an ongoing basis. The creation and redemption process is considerably different from other open-fund funds, however. Among other things, only "authorized participants," generally large financial institutions, can engage with the ETF in the creation or redemption of shares. The authorized participant typically creates ETF shares by buying and delivering a prescribed basket of securities – the "creation basket" – that mirrors the ETF's overall portfolio. In return, the authorized participant receives a block of shares – for example, 50,000 shares – that it can retain or sell *en masse* or in pieces. Figure 3 provides an illustration of the creation of ETF shares.

Figure 3: Creation of ETF Shares[183]



valued in this method as opposed to market value so long as the deviation between the two remain minimal, and results in the computation of the share price that fairly represents the current net asset value per share of the fund." Money Market Fund Potential Accounting Impacts, Association for Financial Professionals, http://www.afponline.org/pub/res/topics/mm/impact.html. As discussed below, the recently finalized MMF reform rule requires institutional prime MMFs to abandon the amortized cost accounting method, so that the portfolio better reflects current market prices.

[180] See discussion infra for description of the run on prime funds in September 2008 following Reserve Primary's breaking the buck.

[181] The special requirements that apply to MMFs are contained primarily in Rule 2a-7 of the '40 Act. 17 C.F.R. 270.2a-7.

[182] The vast majority of ETFs are registered with and regulated by the SEC as investment companies. A small percentage of ETFs invest in commodity futures and are regulated by the CFTC; and an even smaller percentage invest solely in physical commodities and are regulated by the SEC under the '33 Act. *Understanding Exchange-Traded Funds: How ETFs Work* at 10, Investment Company Institute, September 2014, available at http://www.ici.org/pdf/per20-05.pdf.

[183] *Id.* at 7.

The redemption process works in reverse: authorized participants amass ETF shares equal to one "creation unit" and exchange it for the underlying assets that comprise the "creation basket."

ETFs are notable for another reason: many use derivatives to provide returns equal to a multiple of the returns of a given index (a "leveraged" ETF) or to an inverse of the index's returns ("inverse" or "short" ETFs). The SEC and FINRA have issued an investor alert because many investors fail to understand the risk of investing in these types of funds.[184] The risk arises from the fact that "most leveraged and inverse ETFs 'reset' daily, meaning that they are designed to achieve their stated objectives on a daily basis."[185] This means that there is often a disparity between the *cumulative* returns of an index and a leveraged ETF tracking the index over periods of longer than one day. Consider this scenario: An index starts with a value of 100, and an ETF that seeks to provide twice the return of that index starts with a value of $100. On Day 1, the index falls by 15 percent to 85; the ETF falls by twice this amount, or 30 percent, to $70. On Day 2, the index climbs 20 percent, to 102 (85 + (85 x 0.2)). The ETF climbs twice as many percentage points, or 40 percent, to $98 ($70 + ($70 x 0.4)).[186] Over two days, then, the index cumulatively climbed two percent, while the ETF *fell* by two percent. This sort of disparity is not uncommon with leveraged ETFs. Between December 1, 2008 and April 30, 2009, for example, an ETF seeking to provide returns 3X a particular index fell in value by 53 percent, while the index itself *gained* approximately 8 percent.[187]

ETFs have expanded rapidly since their invention in the early 1990s. As of August 2014, approximately 50 sponsors offered over 1,300 ETFs with approximately $1.8 trillion in total net assets.[188] The total asset value of *each* type of investment company over the past three decades is illustrated by Figure 4.

---

184 *Leveraged and Inverse ETFs: Specialized Products with Extra Risks for Buy-and-Hold Investors*, SEC website, http://www.sec.gov/investor/pubs/leveragedetfs-alert.htm.

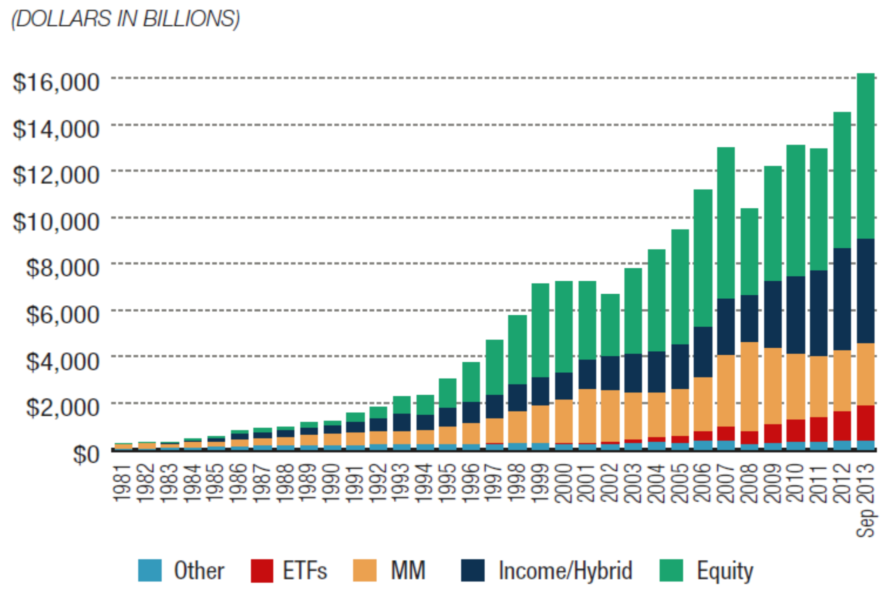
185 *Id.*

186 *Id.*

187 *Id.*

188 *Frequently Asked Questions About the U.S. ETF Market,* Investment Company Institute, http://www.ici.org/etf_resources/background/faqs_etfs_market.

Figure 4: Growth in Assets of the Investment Company Industry, Dec. 1981-Sept. 2013[189]



Note: "Other" Investment Companies include: Unit Investment Trusts and Closed-End funds.

e. Private Funds

Private funds take advantage of exemptions from registration requirements under the '33 and '34 Acts and from regulation under the '40 Act, by (among other things) limiting the number and type of investors that may invest in the funds. There are two types of private funds, based on exemption provisions in '40 Act §3(c). A 3(c)(1) fund is limited to 100 investors, each of which must be "accredited."[190] A 3(c)(7) fund can have up to 1,999 investors (raised from 499 by the JOBS Act), provided they are all "qualified purchasers."[191] Qualified purchasers generally must have at least $5 million in investable assets.[192]

The most prominent types of private funds are hedge funds and private equity funds.[193] While the private fund industry is smaller and much less concentrated than the mutual fund

---

[189] CBJ 2015, supra note 1, at 75.

[190] "Accredited investor" is defined under Rule 501 of Reg D; it generally includes investors with a net financial worth of at least $1 million (not including primary residence) or an annual income of $200,000.

[191] Beverly Goodman, *Hedge Funds Arrive on Madison Avenue*, Barron's, April 28, 2012, http://online.barrons.com/articles/SB50001424053111903591504577361903353035884. Q

[192] *Id.*

[193] See discussion below for definitions.

industry – the assets under management of the largest hedge fund manager (Bridgewater) are just over 2 percent those of the largest mutual fund manager (Blackrock) – the industry as a whole is sizeable. At the end of 2012, hedge funds had $4.77 trillion in regulatory assets under management, and private equity funds had $2.72 trillion in regulatory assets under management.[194] Other private funds had $2.3 trillion in assets under management.[195] Table 5 provides a list of the 10 largest hedge fund managers.

Table 5: Largest Hedge Fund Managers, 7/1/2014[196]

Firm Name	AUM ($B) 7/1/14
Bridgewater Associates	93.7
J.P. Morgan Asset Management	62.6
Och-Ziff Capital Management Group	45.5
BlackRock	34.27
AQR Capital Management	31.6
Baupost Group	29.3
Adage Capital Management	27
Renaissance Technologies	25.5
Elliott Management Corporation	24.8
Davidson Kempner Capital Management	23.7

Table 6 provides a list of the ten largest private equity firms, based on five-year fund-raising totals.

194 Asset Management Study, supra note 154, at 4.

195 *Id.*

196 Source: Lawrence Delevingne, *Rich Get Richer:Assets of Largest Hedge Funds Soar*, CNBC, Sept. 28, 2014, http://www.cnbc.com/id/102030681#.

Table 6: Largest Private Equity Firms, 2014 Rank[197]

Firm Name	Five-year fundraising total ($B)
The Carlyle Group	30.65
Kohlberg Kravis Roberts	27.18
The Blackstone Group	24.64
Apollo Global Management	22.3
TPG	18.78
CVC Capital Partners	16.6
General Atlantic	16.6
Ares Management	14.11
Clayton Dubilier & Rice	13.5
Advent International	13.23

Prior to Dodd-Frank, certain private fund managers, including hedge fund managers and general partners in private equity funds, were exempt from the Investment Advisers Act of 1940. Dodd-Frank repealed the exemption for most private fund advisers – including hedge funds and private equity firms – with assets under management above $100 million. The principal requirements imposed by Dodd-Frank include registration with the SEC and the filing of various information with the SEC and CFTC on the new Form PF. Private fund managers are also now subject to examination by the SEC.

Under the final rule for Form PF,[198] reporting requirements are set for all private funds not otherwise exempt,[199] with heightened requirements prescribed for "large" managers of three particular types of funds: hedge funds, liquidity funds, and private equity funds. A hedge fund is defined generally "to include any private fund having any one of three common characteristics of a hedge fund: (a) a performance fee that takes into account market value (instead of only realized gains); (b) high leverage; or (c) short selling."[200] A liquidity fund is defined as "any private fund

---

197 The rankings are compiled by Private Equity International, and reported in the news media. *See, e.g., The Ten Biggest Private Equity Funds in the World,* May 2, 2014, http://www.growthbusiness.co.uk/news-and-market-deals/business-news/2462432/the-ten-biggest-private-equity-firms-in-the-world.thtml.

198 Final SEC/CFTC Rule on Reporting by Investment Advisers to Private Funds and Certain Commodity Pool Operators and Commodity Trading Advisors on Form PF [hereinafter, Form PF Rule], http://www.sec.gov/rules/final/2011/ia-3308.pdf.

199 The most prominent exemption remains the exemption for venture capital funds.

200 *Id.* at 22-23. Short selling involves betting that the price of a security will fall by borrowing the security (generally from an institutional investor via a broker-dealer) and selling it, with the agreement to return the security at a later date (generally, at the option of either the lender or the borrower). If the price falls, it will cost the short seller less to replace the security than the amount he sold it for.

that seeks to generate income by investing in a portfolio of short-term obligations in order to maintain a stable net asset value per unit or minimize principal volatility to investors."[201] A private equity fund is defined as "any private fund that is not a hedge fund, liquidity fund, real estate fund, securitized asset fund, or venture capital fund and does not provide investors with redemption rights in the ordinary course."[202] Table 7 provides details on size thresholds and frequency of filings that must be made by the various fund managers.

Table 7: Form PF Reporting Requirements[203]

	RAUM Threshold for "Large Adviser" Status	Reporting Frequency	Reporting Timeframe
Large Hedge Fund Advisers	$1.5 billion	Quarterly	within 60 days of the end of each fiscal quarter
Large Liquidity Fund Advisers	$1 billion	Quarterly	within 15 days of the end of each fiscal quarter
Large Private Equity Fund Advisers	$2 billion	Annually	within 120 days of the end of each fiscal year
All Other Advisers	N/A	Annually	within 120 days of the end of each fiscal year

All advisers must provide, among other things, "basic aggregate information about the private funds managed by the adviser, such as the portion of gross (*i.e.*, regulatory) and net assets under management attributable to certain types of private funds," as well as information disaggregated by fund relating size, leverage and performance.[204] Large hedge fund, liquidity fund, and private equity fund advisers are required to file more targeted and detailed information about their funds' performance and risk characteristics.

As mentioned above, in addition to new registration and reporting requirements, registered private fund advisers are now subject to SEC examination. The SEC has devoted significant resources to examining newly registered private fund advisers: it has "vowed to

---

201 *Id.* at 29.

202 *Id.* at 30. A real estate fund is defined in the Form PF glossary as "any private fund that is not a hedge fund, that does not provide investors with redemption rights in the ordinary course and that invests primarily in real estate and real estate related assets." Form PF Glossary, p. 8, http://www.sec.gov/rules/final/2011/ia-3308-formpf.pdf. A securitized asset fund is defined "any private fund whose primary purpose is to issue asset-backed securities and whose investors are primarily debt-holders." *Id.* A venture capital fund is defined by Rule 203(l)-1 of the Advisers Act. 17 C.F.R. 275.203(l)-1. Generally, it must hold itself out as a venture capital fund (e.g., investing in early and mid-stage growth companies), is severely constrained in the leverage it may take on, and cannot offer investors redemption rights.

203 Form PF: Final Rules Adopted by the SEC and CFTC, Skadden Arps Memorandum, April 27, 2012, http://www.skadden.com/newsletters/Form_PF_Final_Rules_Adopted_by_the_SEC_and_the_CFTC.pdf.

204 Form PF Rule, supra note 198, at 64.

examine about 400 of the roughly 1,500 newly registered advisers, and [OCIE Director Andrew] Bowden said the agency is on track to meet that goal by year-end," and has found a number of deficiencies at the hedge funds it has examined to date.[205]

f. Self-Regulatory Organizations

Self-regulatory organizations (SROs) are private entities with quasi-governmental functions; they are "endowed by statute with regulatory authority over specific segments of the market."[206] Because of the inherent conflict of interest involved in self-regulation, the SEC has general supervisory authority over these organizations, including (as mentioned above) approval authority over any rule changes for any SRO, and the power to inspect and examine them.

1) National Securities Exchanges

Exchanges are SROs "responsible for regulating their members for compliance with the securities laws and with their own rules."[207] The major exchanges have delegated their member oversight to the Financial Industry Regulatory Authority, or FINRA. The function and regulation of exchanges is explained in more detail above.

2) Financial Industry Regulatory Authority (FINRA)

FINRA is the enforcement and disciplinary SRO for broker-dealers, formed in 2007 by the merger of the National Association of Securities Dealers (NASD) and the regulatory arm of the New York Stock Exchange.[208] It is a non-profit, independent organization, supported by member fees. It the largest SRO subject to SEC supervision, comparable in size to the SEC itself: it has 3,400 employees spread across 20 offices throughout the United States.[209] All registered broker-dealers are required to be members of FINRA. The SEC thus has a dual relationship with FINRA: it regulates it, but also relies heavily on it as a co-regulator of securities firms.[210]

FINRA's statutory mandate is to help ensure that the securities industry "operates fairly and honestly," by "writing and enforcing rules governing the activities" of securities firms; "examining firms for compliance with those rules; fostering market transparency; and educating

---

205 Andrew Ackerman and Rob Copeland, *SEC Finds Deficiencies at Hedge Funds,* Wall St. J., Sept. 22, 2014, http://online.wsj.com/articles/sec-finds-deficiencies-at-hedge-funds-1411403677.

206 BCG Report, supra note 8, at 20.

207 *Id.* at 21. A complete list of exchanges registered with the SEC can be found at http://www.sec.gov/rules/sro.shtml.

208 "In 1938, the Maloney Act amended the Securities Exchange Act of 1934 to provide for the creation of a regulatory entity that would create and enforce disciplinary rules and promote just and equitable principles of trade. This statute led to the creation of the National Association of Securities Dealers, or NASD, on August 7, 1939. NASD's mandate was 'to protect investors and the public interest, and to remove the impediments to and perfect the mechanism of a free and open market.'" *About FINRA,* FINRA website, http://www.finra.org/AboutFINRA/.

209 *Id.*

210 BCG Report, supra note 8, at 233.

investors."[211] In 2013, FINRA brought 1,535 disciplinary actions against members; levied $65 million in fines; ordered $9.5 million in restitution; and referred 660 cases to the SEC's enforcement division and other agencies.[212]

The SEC exercises oversight of FINRA in two principal ways. First, it must (as with all SROs) approve changes to rules FINRA applies to its members. Second, it routinely inspects key FINRA programs, including FINRA's own examination, surveillance, and enforcement programs.[213]

3) Municipal Securities Rulemaking Board (MSRB)

The MSRB was created by Congress in 1975 as a private, non-profit organization to provide oversight for the $3.7 trillion municipal securities market. It has a 21-member board of directors with "a majority of public members, in addition to representatives of regulated entities."[214] It establishes rules for municipal securities dealers and advisors; collects and disseminates information on the municipal securities market; and conducts market leadership, outreach, and education.[215] The MSRB's rules must be approved by the SEC;[216] unlike FINRA, however, it does not enforce its own rules. Instead, FINRA enforces MSRB's rules for broker-dealers; bank regulators (the Federal Reserve, the OCC, and the FDIC) enforce MSRB's rules for banks; and the SEC enforces MSRB's rules for municipal advisers.[217] The SEC recently established a (small) Office of Municipal Securities to coordinate the SEC's municipal oversight activities generally, including oversight of the MSRB.[218] The Office reviews and processes all MSRB rule filings, leads semiannual meetings with FINRA and MSRB to discuss issues in the municipal securities markets, and meets regularly with MSRB staff.[219] The OCIE has authority to examine the MSRB.

---

211 *About FINRA,* FINRA website, http://www.finra.org/AboutFINRA/.

212 *Id.* FINRA makes publicly available its sanction guidelines, available at http://www.finra.org/web/groups/industry/@ip/@enf/@sg/documents/industry/p011038.pdf. It also provides monthly reports of its disciplinary actions, available at, http://www.finra.org/Industry/Enforcement/DisciplinaryActions/MonthlyActions/2014/index.htm.

213 GAO Report, *Securities Regulation: Opportunities Exist to Improve SEC's Oversight of the Financial Industry Regulatory Authority*, May 2012, GAO-12-625. The GAO report, mandated by Dodd-Frank § 964, identified several gaps in the SEC's oversight of FINRA, including a lack of retrospective review of FINRA rules, and a lack of oversight of FINRA's own operations, such as governance and executive compensation.

214 MSRB Mission Statement, http://www.msrb.org/About-MSRB/About-the-MSRB/Mission-Statement.aspx.

215 *Id.*

216 *MSRB Rulemaking,* SEC website, http://www.sec.gov/rules/sro/msrb.shtml.

217 *Market Oversight*, MSRB website, http://www.msrb.org/About-MSRB/Programs/Market-Regulation.aspx.

218 CBJ 2015, supra note 1, at 104.

219 *Id.*

4) Public Company Accounting Oversight Board (PCAOB)

PCAOB is private, non-profit organization created by the Sarbanes-Oxley Act in the wake of the corporate accounting scandals of the early 2000s to oversee accounting standards and audits for public companies. PCAOB responsibilities include “registering public accounting firms; establishing auditing, quality control, ethics, independence, and other standards relating to public company audits; conducting inspections, investigations, and disciplinary hearings of registered accounting firms; and enforcing compliance with Sarbanes-Oxley.”[220] Sarbanes-Oxley requires PCAOB to inspect public accounting firms on a regular basis. PCAOB must inspect accounting firms that audit more than 100 issuers an annual basis, and those that audit fewer than 100 firms at least once every three years.[221] PCAOB prepares a report for each inspection and delivers it to the SEC and relevant state authorities.[222] PCAOB also has authority to “investigate and discipline registered public accounting firms and persons associated with those firms for noncompliance with the Sarbanes-Oxley Act of 2002, the rules of the PCAOB and the Securities and Exchange Commission, and other laws, rules, and professional standards governing the audits of public companies, brokers, and dealers.”[223] Investigations are nonpublic unless and until a final decision imposing sanctions is issued.[224] Sanctions may include suspension or revocation of registration for individuals or firms; a requirement that a firm hire an independent monitor to ensure compliance going forward; and the imposition of fines.[225]

The SEC has oversight authority for PCAOB, including approval authority of its rules and budget,[226] and the authority to hear appeals from any PCAOB disciplinary actions.[227] The OCIE also has authority to examine PCAOB and its operations.

5) Securities Investor Protection Corporation (SIPC)

SIPC was created by the Securities Investor Protection Act (SIPA) of 1970, following the collapse of several broker dealers in the late 1960s.[228] In a broker-dealer liquidation, SIPC serves a function somewhat analogous to the FDIC’s role in a bank resolution. Either as trustee itself or

---

220 *Public Company Accounting Oversight Board (PCAOB)*, SEC website, http://www.sec.gov/answers/pcaob.htm.

221 *Inspections*, PCAOB website, http://pcaobus.org/Inspections/Pages/default.aspx.

222 *Id.*

223 *Enforcement,* PCAOB website, http://pcaobus.org/Enforcement/Pages/default.aspx.

224 *Id.*

225 Dennis K. Spillane, *PCAOB Enforcement: What to Expect,* The CPA Journal Online, http://www.nysscpa.org/cpajournal/2004/904/essentials/p32.htm.

226 Though the SEC approves PCAOB’s budget, PCAOB funds itself primarily through “annual accounting support fees” assessed on public companies. *About the PCAOB,* PCAOB website, http://pcaobus.org/about/pages/default.aspx.

227 *Public Company Accounting Oversight Board (PCAOB)*, SEC website, http://www.sec.gov/answers/pcaob.htm. *See also* http://www.sec.gov/rules/pcaob.shtml.

228 *SEC’s Oversight of the Securities Investor Protection Corporation’s Activities* at iv, U.S. Securities and Exchange Commission, Office of the Inspector General, Office of Audits, Mar. 30, 2011 [hereinafter SIPC Oversight Report], available at http://www.sec.gov/oig/reportspubs/495.pdf.

in conjunction with a court-appointed trustee, SIPC oversees the firm's liquidation and expedites the return of customer assets, guaranteeing the return of *missing* customer assets of up to $500,000 in securities and cash (with a $250,000 limit for cash).[229] SIPC does *not* protect against losses from declines in the market value of assets; it only protects against loss or theft of customer assets.[230] SIPC is funded by member assessments on broker-dealers, and the current target level of the SIPC fund is $2.5 billion.[231] Under SIPA, the SEC has authority "to conduct inspections of SIPC, review SIPC annual reports, and approve SIPC bylaws, rules, and any amendments to the bylaws and rules."[232]

6) Financial Accounting Standards Board (FASB)

FASB is a private, nonprofit organization "dedicated to setting the financial accounting standards that collectively are known as U.S. Generally Accepted Accounting Principles, or U.S. GAAP."[233] While FASB is formally subject to oversight by a foundation, the Financial Accounting Foundation, the SEC has the authority to "change or disapprove rules proposed by FASB, although this authority is rarely executed."[234]

7) Clearing Agencies

When a security is traded, the seller agrees to deliver the security and the buyer (generally) agrees to deliver cash; the process by which the exchange is consummated is known as clearance and settlement.[235] Entities that provide clearance and settlement services are called clearing agencies. All securities clearing agencies are SROs registered with the SEC, and may be one of two types: clearing corporations or depositories.[236]

Clearing corporations "compare member transactions (or report to members the results of exchange comparison operations), clear those trades and prepare instructions for automated settlements of those trades, and often act as intermediaries in making those settlements."[237] Notable clearing corporations in the United States include the National Securities Clearing

---

229 *Id.; SIPC Mission*, SIPC website, http://www.sipc.org/about-sipc/sipc-mission.

230 *Securities Investor Protection Corporation (SIPC)*, SEC website, http://www.sec.gov/answers/sipc.htm.

231 *The SIPC Fund,* SIPC website, http://www.sipc.org/about-sipc/the-sipc-fund.

232 SIPC Oversight Report, supra note 228, at iv. While the report found that SEC's oversight of SIPC was generally in compliance with SIPA, it could be improved significantly. Among other things, "the SEC does not inspect SIPC's activities in any systematic fashion. The SEC last performed a full inspection of SIPC in 2003 and a follow-up inspection in 2005. Despite having made six findings in its 2003 inspection, the SEC does not have any definite plans to inspect SIPC in the near future." *Id.* at vi.

233 *What We Do: FASB,* Financial Accounting Foundation website, http://www.accountingfoundation.org/jsp/Foundation/Page/FAFSectionPage&cid=1351027541293.

234 BCG Report, supra note 210, at 237.

235 *Oversight of U.S. Equities Market Clearing Agencies*, report by US Government Accountability Office, GAO-09-318R [hereinafter Clearing Agency Report], Feb. 26, 2009, available at http://www.gao.gov/products/GAO-09-318R.

236 *Clearing Agencies,* SEC website, http://www.sec.gov/divisions/marketreg/mrclearing.shtml.

237 *Id.*

Corporation (NSCC), the Fixed Income Clearing Corporation (FICC), and the Options Clearing Corporation (OCC).[238]

A depository, in contrast, holds "securities certificates in bulk form for their participants and maintain ownership records of the securities on their own books. Physical securities are maintained in vaults, and ownership records are maintained on the books of the depository."[239] The dominant depository in the United States is the Depository Trust Company (DTC). The DTC is a limited purpose trust company under New York banking law, and is regulated by the Federal Reserve and New York state banking authorities in addition to the SEC.[240]

The DTC, NSCC, and FICC are subsidiaries of the Depository Trust and Clearing Corporation (DTCC). "Virtually all equity securities trades in the United States are cleared and settled through" the NSCC and DTC.[241] In addition to equities, the NSCC processes trades for corporate debt, municipal securities, mutual funds, annuities, and unit investment trusts.[242] The FICC provides clearing and settlement services for U.S. Treasury securities, agency debt securities, and mortgage-backed securities. The OCC is an independent clearing agency regulated by the SEC in conjunction with the CFTC. Under SEC jurisdiction, the OCC clears equity options, exchange-listed options, security futures and OTC options.[243] Other clearing agencies registered with the SEC include the Boston Stock Exchange Clearing Corporation, Chicago Mercantile Exchange, ICE Clear Credit, and ICE Clear Europe.[244]

Under Dodd-Frank, the SEC must examine "covered clearing agencies" each year. Other clearing agencies are examined on a two-year cycle.[245] Covered clearing agencies subject to heightened regulation by the SEC include (i) those designated as systemically important by the FSOC, and (ii) clearing agencies acting as a central counterparty in clearing swaps or other risky activities, unless the FSOC has designated the clearing agency as systemically important *and* the clearing agency's primary regulator is the CFTC.[246] There is also a catch-all for the SEC to designate other clearing agencies as covered at its discretion.[247] Covered clearing agencies that have been designated by the FSOC as systemically important and whose primary regulator is the

---

[238] *Id.*

[239] *Id.*

[240] *Oversight of Key Financial Market Infrastructures* [hereinafter Financial Market Infrastructures], Federal Reserve System website, http://www.federalreserve.gov/paymentsystems/over_pssystems.htm.

[241] Clearing Agency Report, supra note 235.

[242] Key Financial Market Infrastructures, supra note 240.

[243] *Clearing & Services,* OCC website, http://www.optionsclearing.com/clearing/.

[244] SEC website, http://www.sec.gov/rules/sro.shtml.

[245] CBJ 2015, supra note 1, at 68.

[246] Annette Nazareth, *Why the Market Should Care About Proposed Clearing Market Requirements*, HLS Forum on Corporate Governance and Financial Regulation, http://blogs.law.harvard.edu/corpgov/2014/04/07/why-the-market-should-care-about-proposed-clearing-agency-requirements/.

[247] *Id.*

SEC include the DTC, FICC, NSCC and OCC.[248] ICE Clearing Europe is a covered clearing agency under the second prong above.[249] (The Chicago Mercantile Exchange and ICE Clear Credit have been designated as systemically important, but are subject to heightened supervision and regulation by the CFTC rather than the SEC.[250])

SEC rules for clearing agencies generally require them to establish and enforce policies and procedures related to transparency and risk management. For example, if acting as a central counterparty, clearing agencies must measure credit exposures to each participant at least once a day; use margin requirements to limit exposure to participants; maintain sufficient resources to survive a default by a participant; and provide for an annual independent modeling audit.[251]

The SEC has proposed but not finalized a rule providing for enhanced regulation of covered clearing agencies.[252] Many of the requirements "reflect enhancements of the SEC's existing oversight program for registered clearing agencies," while others "would be newly specified in light of the nature and extent of the activities of covered clearing agencies."[253] The latter include rules relating to the qualifications of covered clearing agencies officers and directors; standards of independence for the covered clearing agencies' internal risk management and audit personnel; and various aspects of financial risk management and general business risk management.[254]

g. Transfer Agents

Transfer agents stand as intermediaries between issuers and holders of securities, recording changes of ownership, issuing and canceling certificates, and distributing dividends.[255] There are approximately 450 transfer agents, of which approximately 100 are banks and registered with a bank regulatory agency, and approximately 350 are non-banks registered with the SEC.[256] The SEC conducts examinations of approximately 10 percent of transfer agents annually.[257] It has also promulgated rules establishing minimum standards for recordkeeping and

---

248 *Id.*

249 *Id.*

250 *Id.*

251 SEC website, http://www.sec.gov/News/Article/Detail/Article/1365171586143#.VFYa98k8Sm1.

252 http://www.sec.gov/rules/proposed/2014/34-71699.pdf.

253 SEC Fact Sheet, Enhanced Regulatory Framework for Covered Clearing Agencies, Mar. 12, 2014, http://www.sec.gov/News/PressRelease/Detail/PressRelease/1370541113410#.VFYdtck8Sm0.

254 *Id.*

255 *Transfer Agents*, SEC website, http://www.sec.gov/divisions/marketreg/mrtransfer.shtml.

256 CBJ 2015, supra note 1, at 72.

257 *Id.* at 61.

reporting, and for "the prompt and accurate creation of security holder records and the safeguarding of securities and funds."[258]

h. Credit Rating Agencies

Credit ratings agencies assess the creditworthiness of issuers or particular debt instruments, using symbols to communicate their assessments (as illustrated in the table below). The industry has traditionally been dominated by Moody's, S&P, and Fitch (the "Big Three"). Federal statutes and regulations were replete with requirements that particular institutions – banks, money market funds, mutual funds, and so on – comply with investment rules defined (in part) by credit ratings. To meet statutory and regulatory requirements, credit ratings had to be issued by SEC-designated "Nationally Recognized Statistical Rating Organizations" (NRSROs). Aspiring new credit rating agencies faced a catch-22: issuers did not want to employ them unless their ratings carried the "regulatory license" that NRSRO status implied; but the SEC would not designate them as "nationally recognized" unless issuers began using them. This served as an almost insurmountable barrier to entry for new credit ratings agencies until 2006. (A few small agencies managed to squeak through from time to time, but tended to be bought by one of the Big Three.)

Meaning of Credit Ratings

	Credit Rating Agency		
Credit Quality	**Moody's**	**S&P**	**Fitch**
	Investment grade		
Highest credit quality	Aaa	AAA	AAA
High credit quality	Aa1 to Aa3	AA+ to AA-	AA
Strong payment capacity	A1 to A3	A+ to A-	A
Adequate payment capacity	Baa1 to Baa3	BBB+ to BBB-	BBB
	Speculative grade		
Possibility of credit risk	Ba1 to Ba3	BB+ to BB-	BB
Significant credit risk	B1 to B3	B+ to B-	B
High credit risk	Caa1 to Caa3	CCC+ to CCC-	CCC
Default is likely / imminent	Ca	CC, C	CC, C
In default	C	SD, D	D

Source: Financial Crisis Inquiry Commission, *Preliminary Report: Credit Ratings and the Financial Crisis*

In 2006, Congress passed the Credit Rating Agency Reform Act,[259] requiring NRSROs to register with the SEC, but also providing for a streamlined NRSRO application process. The

[258] *Transfer Agents,* supra note 255.

motivation was to increase competition in the credit ratings industry, under the view that the Big Three's "oligopoly" might have a deleterious effect on the quality of their ratings. Currently there are 10 NRSROs,[260] and while the Big Three still dominate the overall market, several of them have managed to establish reasonable toeholds in specific sectors.[261]

The Dodd-Frank Act made several significant changes to the regulation of the ratings industry. Perhaps most importantly, it mandated that all NRSRO references be stripped from federal statutes, rules, and regulations. This process has largely been completed, with a few lingering references left to expunge.[262] The mandate was likely motivated in part by the view that NRSROs' status as "regulatory licensor" facilitated "ratings arbitrage" in the run-up to the crisis – that is, institutional investors constrained by statute or rule from taking on too much credit-risk, as defined by the NRSRO ratings, understood that ratings on certain structured products were too optimistic. Instead of avoiding these mis-rated instruments, however (critics argue), institutional investors embraced them: this approach allowed them to take more risk than they would otherwise have been able to assume. With more risk came higher returns (and thus higher compensation) if the instruments did not default. (This depends, of course, on riskier bonds actually offering higher yields despite credit ratings identical to "safer" bonds. This could occur (a) because the market does not believe the credit ratings even as it embraces them for purposes of regulatory arbitrage; or (b) because of other types of risk, such as interest rate risk.) If things went awry, fund managers' downside was truncated since they were investing other people's money. Other justifications for the mandate to remove NRSRO references include forcing asset managers to conduct their own assessments of credit risk, and eliminating what some may have seen as a government imprimatur for NRSRO ratings.

It is worth noting, however, that NRSRO references remain in place as a risk constraint in many fund charters and private contracts, and asset managers will likely still depend on them even when they are not required to do so, as a way to help mitigate potential liability in the event of losses.

Another significant change Dodd-Frank brought to the regulation of the credit rating industry was the creation of a new Office of Credit Ratings. The office is responsible for conducting annual examinations of every NRSRO and for reporting to Congress each year on issues such as the status of proposed rules, transparency, and competition within the ratings industry generally.[263]

---

259 https://www.sec.gov/divisions/marketreg/ratingagency/cra-reform-act-2006.pdf.

260 A full list can be found at http://www.sec.gov/ocr#.VFKsmRY8Sm0.

261 Annual Report on Nationally Recognized Statistical Rating Organizations at 10, December 2013, Securities and Exchange Commission, available at http://www.sec.gov/divisions/marketreg/ratingagency/nrsroannrep1213.pdf.

262 The SEC recently reproposed a rule to strip references to NRSRO ratings from Rule 2a-7, governing money market fund investments.

263 *About the Office of Credit Ratings,* SEC website, http://www.sec.gov/about/offices/ocr/ocr-about.shtml#.VCQENxa6980.

Finally, in August 2014, the SEC finalized a host of new rules for NRSROs.[264] The new rules for ratings agencies prescribe standards to which the NRSROs must adhere when establishing and maintaining a system of internal controls; enhancements to disclosures of each NRSRO's ratings performance history; stronger measures to ensure business concerns do not affect (i.e., inflate) ratings; and standards for training, experience, and competence of ratings staff.[265]

i. Securitization, Structured Finance, and Asset-backed Securities

Securitization refers to the process of pooling credit claims of various sorts into a special purpose entity and issuing securities against the entity. Some securitizations – most notably, single-class mortgage-backed securities issued by Fannie Mae, Ginnie Mae, or Freddie Mac[266] – are "pass-through," meaning all investors in the MBS receive pro-rata shares of the payments made on the mortgages in the MBS pool. Most other types of securitizations, including the vast majority of private-label mortgage-backed securities, involve the issuance of a hierarchy of securities in "tranches" to investors. Pooling and tranching together constitute "structured finance." Figure 7 provides an illustration of the securitization process with a private-label residential mortgage-backed security (RMBS), in which in which the monthly principal and interest from thousands of mortgage owners flow into a special entity called a real estate mortgage investment conduit (REMIC), and the cash is then used to pay RMBS investors.

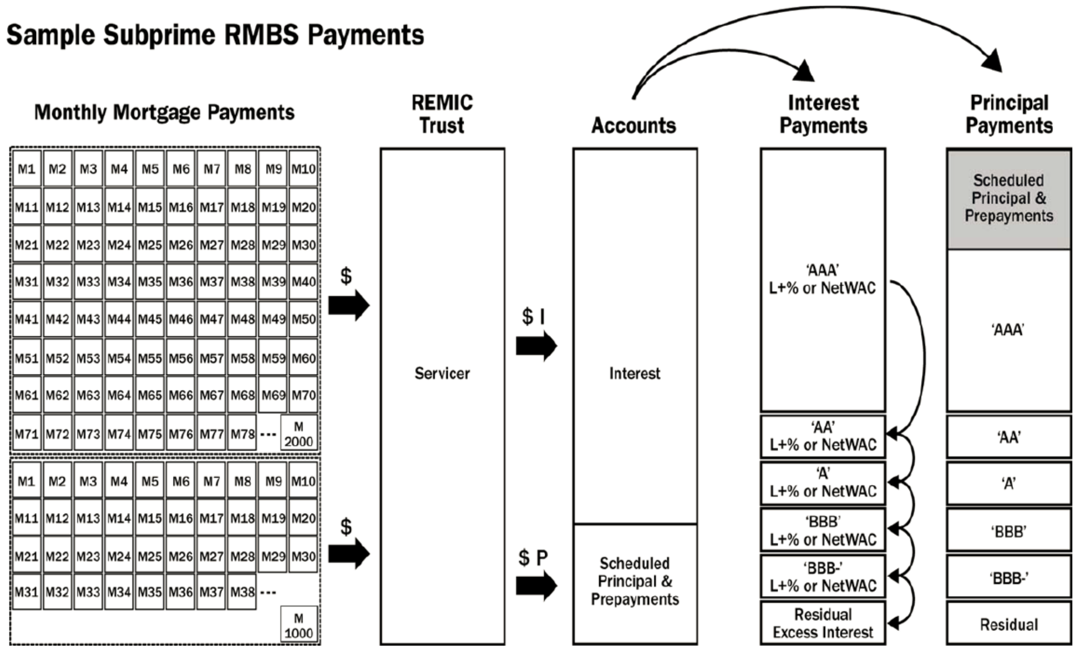
---

264 http://www.sec.gov/rules/final/2014/34-72936.pdf,

265 *Id.*

266 The GSEs also issue mortgage-backed securities in tranches, as described below, but they call these "CMOs," or collateralized mortgage obligations.

Sample Subprime RMBS Payments[267]



The top tranche has the first claim on cash flowing in from the mortgages; indeed, each tranche in the hierarchy is due to receive all its principal back before any of the lower tranches receive any.[268] The lower the tranche, the riskier the investment (though the higher the interest received if the loan performs). A *sine qua non* of the securitization process outside the GSEs is credit ratings. The top credit rating, AAA, is usually assigned to the top tranche; in the run-up to the crisis, the large majority of each RMBS – typically 80 percent – received the top rating, even those comprised of subprime loans.

The assignment of top ratings to slices of pools of very risky assets may look suspect in hindsight, but it rested on a sound theoretical basis. As long as assets are imperfectly correlated, pooling and tranching can produce debt instruments with lower credit risk than any individual asset in the pool. The figure below provides a highly stylized illustration of this: suppose two mortgages, each worth $100 and each with a 10 percent chance of default (with no recovery in the event of default), are pooled, and two mortgage-backed securities are issued against this pool in tranches. The tranches each have a face value of $100. The senior MBS in this case will only default if *both* mortgages default, and the junior MBS will default if *either* mortgage defaults. As long as performance on the mortgages is not perfectly correlated, the senior MBS will be less risky than either of them individually. If the mortgages are completely independent of each

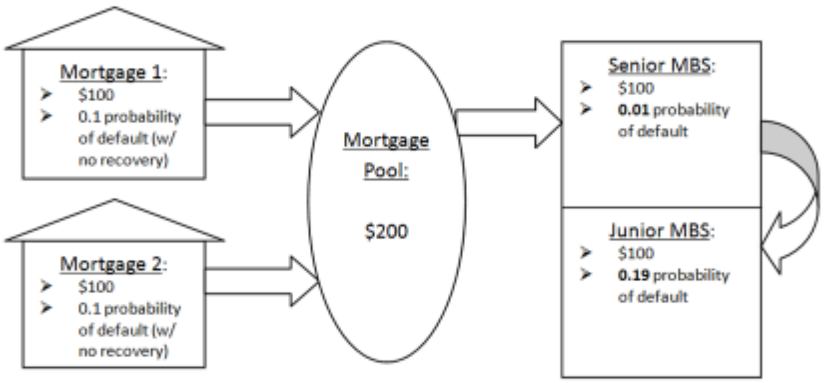
---

[267] Source: Gary Gorton, "The (Ongoing) Panic of 2007-2008" (Presentation Slides)

[268] There are mechanisms in most RMBS to provide for pro rata distribution after several years if various performance metrics are met, assuring the higher tranches of repayment.

other, the senior bond will have a default probability of .01 (or 1 percent). By concentrating risk in the bottom of the hierarchy, it is possible to create "safe" assets at the top of the hierarchy.

Pooling and Tranching (with no correlation)[269]



The key assumption for this process to work – for senior tranches issued against a pool to be safer than any of the assets in the pool – is imperfect correlation. The figure above assumes no correlation; at the other extreme, one could imagine a pool of the common shares of one particular company (say, Coca Cola), which are perfectly correlated with each other in the return they provide. Issuing securities in tranches against a pool of such shares would accomplish nothing: either all of Coke's shares will (for example) pay a dividend, or none will.

In general, the less correlated the performance of the assets in a pool, the easier it is to construct "safe" securities through tranching. The ratings agencies' largest modeling error leading up to the crisis was underestimating how default correlations might rise in an environment with highly leveraged homeowners, falling house prices, and high unemployment (as well as shifting social mores with respect to defaulting on a mortgage).

It is worth noting that ratings play a key role for *private*-label MBS, and these are overwhelmingly the mortgages that did not qualify for agency (e.g., Fannie Mae and Freddie Mac) securitization. There are three general reasons a mortgage might not qualify: it is too large, or "jumbo"; the mortgagor's credit score is too low, in which case the mortgage is "subprime"; or the underwriting standards are relaxed – as with "low-doc" and "no-doc" loans, or with high loan-to-value ratios – in which case the mortgage is "alt-A."

Many other assets besides mortgages are securitized, such as automobile debt and credit card debt. Most of these other securitizations are called asset-backed securitizations, or ABS. Table 8 provides a breakdown of total private securitizations outstanding through the third

[269] Source: Crawford, CDO Ratings

quarter of 2014, by different categories. (Through the second quarter of 2014, outstanding *agency* (i.e., non-private) mortgage-backed securities totaled just over $7 trillion.[270])

Table 8: Total Outstanding Private US ABS and MBS, Q3 2014 (in $ billions)[271]

Commercial Mortgage-Backed Securities (CMBS)	623.1
RMBS	976.2
Subtotal, mortgage related	**1,599.3**
Automobile	178.2
Credit card	135.0
Equipment	48.3
Housing-related[272]	265.9
Student loans	216.4
Other[273]	109.8
CDO	610.0
Subtotal, ABS	**1,563.6**
Total	**3,062.9**

One type of asset-backed security worth highlighting is the collateralized debt obligation, or CDO. Some CDOs are made from bank loans; these are sometimes called "collateralized loan obligations," or CLOs. Some CDOs are made from corporate bonds; these are sometimes called "collateralized bond obligations," or CBOs. And some are made from *other* structured financial products, such as MBS. CDOs constructed from other structured financial products constitute "second-level" securitizations. Lower-rated tranches from these CDOs were then often repackaged into *new* CDOs, called CDOs-squared.[274]

In the run-up to the crisis, the SEC directly regulated securitization through Regulation AB (Reg AB), which codified previous SEC guidance and practices, and became effective in 2005.[275] Reg AB imposed requirements on asset-backed securities offerings relating to, among other things, registration, disclosures, and reporting. Reg AB did not apply to agency securities,

---

270 *Statistics*, Securities Industry and Financial Markets Association (SIFMA) website, http://www.sifma.org/research/statistics.aspx (click on "US Mortgage-Related Issuance and Outstanding"). Agency mortgage-related securities are issued by Fannie Mae, Freddie Mac and Ginnie Mae and include pass-through MBS as well as (tranched) CMOs.

271 *Statistics,* SIFMA website, http://www.sifma.org/research/statistics.aspx, (click on "US Mortgage-Related Issuance and Outstanding" and on "US ABS Issuance and Outstanding").

272 "Housing-related" does not include mortgages but rather claims on income streams from rentals, as well as servicing advances. *Id.*

273 "Other" is a very broad category that includes such varying items as structured settlements and cell tower leases.

274 "While one occasionally sees references to CDO-cubeds, the collateral for these exponential CDOs was usually a mélange of securities that had gone through varying numbers of securitization iterations." Crawford, *CDO Ratings*.

275 http://www.sec.gov/rules/final/33-8518fr.pdf.

nor did it cover private placements. While many ABS and MBS were registered and sold in public offerings, CDOs were offered almost exclusively in private placements, and were thus formally exempt from registration and the disclosure requirements that went along with it.

In September 2014, the SEC finalized new rules for asset-backed securities offerings.[276] The new rules enhance the required loan-level disclosure for deals and require a three-day lag between the filing of a preliminary prospectus and the first sale of the security, to ensure investors have enough time to digest and analyze the transaction-specific information.[277] These rules apply only to registered offerings. As noted above, CDOs were exclusively privately placed, so these new rules would not apply to them.

In October 2014, the SEC also finalized a "risk retention rule," a joint rule by a sestet of agencies: the SEC, the Federal Reserve Board, the FDIC, the FHFA, HUD, and the OCC.[278] The rule was mandated by Dodd-Frank § 941, and arose from a view that securitization facilitates moral hazard as the "originators" – those creating special purpose vehicles, pooling assets, and selling securities – were not as careful in assessing credit risk as they would have been if they were retaining rather than "distributing" the risk to others.[279] The final rule requires securitizers to retain at least five percent of the credit risk of any ABS they sell to third parties, and prohibits them from hedging or transferring that risk, directly or indirectly. ABS sponsors may satisfy this requirement "vertically," by retaining a 5 percent interest in each tranche issued, or "horizontally," by retaining the most subordinated tranche(s) in an amount equal to 5 percent of the entire ABS. Importantly, MBS collateralized exclusively by "Qualified Residential Mortgages" (QRMs), all performing at MBS issuance, are *exempt* from the risk retention rule. QRMs must meet a number of standards that serve as proxies for repayment likelihood, including (among many other things) no negative amortization, no balloon payments, maximum loan term of 30 years, and total debt-to-income ratio not exceeding 43 percent.[280]

3. Derivatives

The CFTC retains jurisdiction over the vast majority of derivatives in terms of notional value, and an extensive description of derivatives markets and products is provided in Part II. It is worth noting here, however, that the SEC has jurisdiction over "security-based swaps," which includes "swaps based on a single security or a narrow-based index of securities," while the

---

[276] http://www.sec.gov/rules/final/2014/33-9638.pdf.

[277] *Id.*

[278] Joint Press Release, available at http://www.federalreserve.gov/newsevents/press/bcreg/20141022a.htm.

[279] In a common version of this narrative, buyers trusted the ratings agencies, and the ratings agencies, paid by the issuers, made excessively optimistic modeling assumptions in order not to lose business.

[280] "The Final Rules define a QRM to be the same as a qualified mortgage ("QM"), as defined in Section 129C of The Truth in Lending Act and implemented by the Consumer Financial Protection Bureau ("CFPB") in its ability to repay rule, as amended from time to time." *Final Credit Risk Retention Requirements for Asset-backed Securities Transactions*, Cadwalader Clients & Friends memo, Oct. 30, 2014.

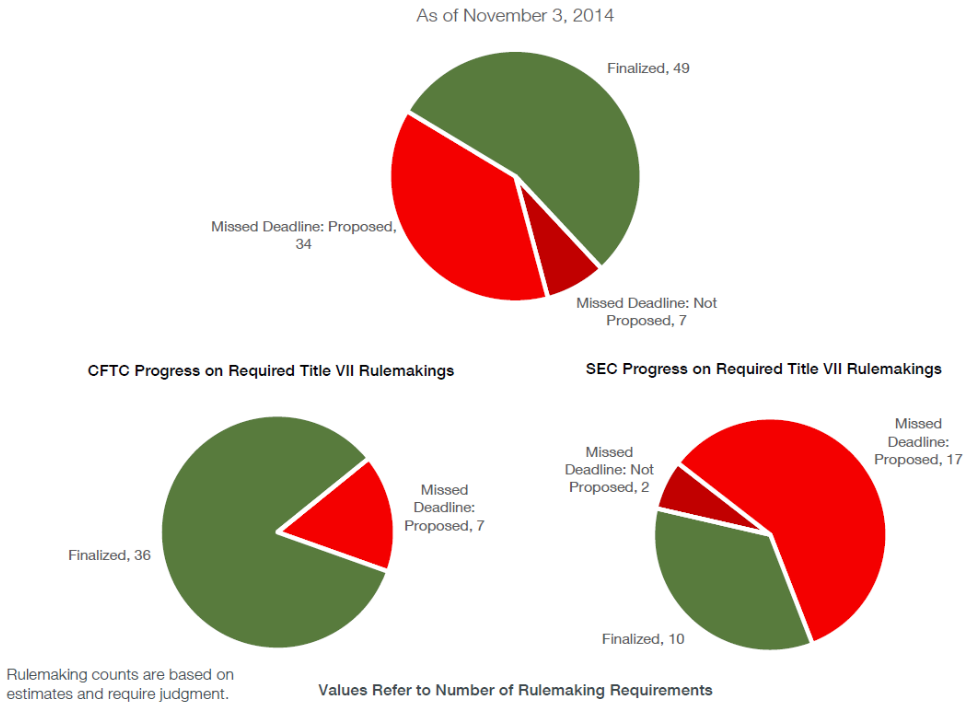
CFTC has jurisdiction over swaps based on broad-based indices and most other reference assets. For "mixed swaps," the SEC and CFTC have joint jurisdiction.

Dodd-Frank Title VII mandated a host of new rules relating to swaps oversight. The provisions of Title VII are extensive. Some of the major requirements include the creation of new categories of market participants subject to regulation and supervision of their swap-based activities. These new categories include "swap dealers," "security-based swap dealers," "major swap participants," and "major security-based swap participants." The SEC and CFTC have issued a final joint rule defining these categories.[281] Other new categories of market participant include "swap execution facilities," which function as limited-scope exchanges for swaps, and "swap data repositories" (SDRs), which receives and reports all data on all swaps, whether cleared or not. For more extensive descriptions of all these terms, please refer to the CFTC memo prepared in parallel with this memo.

The rules applied by the SEC to security-based swaps and the swap-related entities created by Dodd-Frank will likely be somewhat analogous to the CFTC's regulation, where it is not identical (as in the case of joint rules). The SEC seriously lags the CFTC, however, in finalizing its Title VII rules. Figure 10 shows that whereas the CFTC has finalized the large majority of its Dodd-Frank Title VII rules (36 of 43), the SEC has finalized only a bit more than a third of its title VII rules (10 of 29).

[281] http://www.sec.gov/rules/final/2012/34-66868.pdf.

Figure 5: Title VII Progress on Required Rulemakings[282]



II. THE COMMODITY FUTURES TRADING COMMISSION

A. Background

The CFTC is the primary U.S. regulator of derivatives. Its regulatory scope has expanded dramatically in the wake of the financial crisis and the Dodd-Frank Act. Dodd-Frank dramatically changed how derivatives – forwards, futures, options, swaps, and other instruments – are regulated in the United States. Until 2010, the vast majority of notional interest in derivatives went largely unregulated. Volume primarily existed in the form of bilateral contracts in which each party had credit exposure to each other. Trades were negotiated largely through an informal dealer network, and regulators had little transparency into markets.[283]

To be sure, regulated derivatives markets existed and functioned reasonably well. Exchange-traded futures and options markets in agricultural, energy, commodity, and financial products were deep, liquid, and resilient. During the credit crisis, these markets adjusted to the default of large participants. Clearinghouses, also known as designated clearing organizations

[282] Dodd-Frank Progress Report, November 2014, Davis Polk & Wardwell.

[283] Regulators gained limited transparency into these markets in the years leading up to the financial crisis through the work of the "Over-the-counter Derivatives Supervisors Group" (ODSG), which encourages derivatives dealers to improve their back-office functions and provide regulators with some understanding of their bilateral exposures. This transparency was limited, however, and was not legally mandated until passage of the Dodd-Frank Act.

(DCOs), absorbed the collapse of Lehman Brothers, and their default procedures largely functioned as intended, albeit with some challenges along the way.[284]

But most derivatives in the U.S. fell outside the CFTC's jurisdiction. The Dodd-Frank Act changed that. Now, virtually all derivatives in the U.S. are subject to some form of CFTC (or SEC) jurisdiction. These instruments are subject to clearing requirements, market transparency requirements, and reporting requirements. Entities "dealing" them must register with the CFTC, meet capital and margin requirements, and comply with business conduct requirements. DCOs must meet stronger risk management requirements. Trading platforms, many of them new, now facilitate the execution of a large number of transactions and do so consistent with rules designed to foster pre-trade market transparency. And all trades are subject to mandatory reporting, both to foster price transparency and to ensure that regulators have a greater understanding of the state of the market.

To an overwhelming degree, these requirements have been implemented and are now overseen by the CFTC, an agency that employs slightly fewer than 700 people and has an annual budget of approximately $235 million. The agency has drawn increased attention since the passage of the Dodd-Frank Act given its expanded jurisdiction. Other federal regulators such as the Board of Governors of the Federal Reserve (the Federal Reserve), the Federal Deposit Insurance Corporation (FDIC), the Office of the Comptroller of the Currency (OCC) (collectively, the Banking Regulators), and the SEC, were far better known and understood by market participants.

This section is not meant to be a summary of the recent legislative and regulatory changes, though it addresses them. Instead, the paper outlines how the CFTC "works": how it is structured and how it fulfills its mission as the primary regulator of derivatives contracts in the U.S.

B. History and Statutes

While agricultural futures markets date back to at least the 1860s in the U.S., the CFTC, and, more generally, derivatives regulation in the U.S., trace their origins to the 1920s. In 1921, Congress enacted the Future Trading Act, which provided for the regulation of futures trading in grain – i.e., corn, wheat, oats, and rye.[285] Under the Future Trading Act, the Secretary of Agriculture was empowered to designate exchanges that met certain requirements as "contract markets" in grain futures.[286] The intent was to encourage trading on contract markets, and as

[284] For a broader discussion of the challenges faced in resolving Lehman Brothers' positions at certain clearinghouses, see generally the Bankruptcy Examiner's Report concerning Lehman Brothers. *In re Lehman Brothers Holdings, Inc.*, 08-13555 (Bankr. S.D.N.Y.), Dkt. No. 7531.

[285] H.R. 5676 enacted as Pub. L. No. 67-66, 42 Stat. 187 (codified as 7 U.S.C. § 1 (1921)).

[286] 7 U.S.C. § 5 (1921).

such, the Future Trading Act imposed a tax of $0.20 per bushel on all options and grain future contracts not executed on a designated contract market.[287]

The following year, however, the Supreme Court in *Hill v. Wallace*[288] held that the Future Trading Act was unconstitutional because it was predicated on Congress' taxing power but was not designed to be, nor functioned as, a revenue-raising measure. In particular, the Court noted that a twenty-cent tax on every grain futures contract not executed on a designated contract market was prohibitive and would preclude such contracts.[289]

After the Future Trading Act's demise, Congress responded by passing the Grain Futures Act, which included similar provisions to the Future Trading Act, such as the requirements for the designations of contract markets.[290] Unlike the Future Trading Act, however, Congress based the Grain Futures Act on the interstate commerce clause and the Supreme Court subsequently affirmed its constitutionality in *Board of Trade of City of Chicago v. Olsen*.[291]

The Grain Futures Act created the Grain Futures Administration within the Department of Agriculture, which functioned as the CFTC's predecessor. The Grain Futures Administration reported grain futures transactions and investigated dissemination of misleading information that was likely to affect grain prices.[292] The Grain Futures Act also created the Grain Futures Commission, which consisted of the Secretary of the Agriculture, the Secretary of Commerce, and the Attorney General, and regulated grain futures exchanges.[293]

Like the Future Trading Act, the Grain Futures Act prescribed a system of federal regulation in which exchanges were licensed as "designated contract markets" for the trade of particular futures, a category of regulated entity that continues to exist today.[294] Under this regime, the Secretary of Agriculture would monitor the exchanges' activities. If the exchanges failed to comply with the statute, then the Secretary could revoke an exchange's designation.

The Grain Futures Act significantly restricted who could participate in agricultural futures markets. For example, Section 4 of the act prohibited the use of the mail or wires to offer or accept sales of grain for future delivery or to disseminate prices or quotations, except for individuals who actually held the grain being sold, the individuals who owned or rented the land

---

287 7 U.S.C. § 4 (1921).

288 259 U.S. 44, 66 (1922).

289 *Id*. at 48.

290 H.R. 11843 enacted as Pub. L. No. 67-331, 42 Stat. 998 (codified as 7 U.S.C. § 1 (1922)).

291 262 U.S. 1 (1923).

292 Jeremy Gogel, *Shifting Risk to the Dumbest Guy in the Room-Derivatives Regulation After the Wall Street Reform and Consumer Protection Act*, 11 J. Bus. & Sec. L. 1, 16 (2010).

293 Gogel, 11 J. Bus. & Sec. L. at 16.

294 John H. Stassen, *The Commodity Exchange Act in Perspective A Short and Not-So-Reverent History of Futures Trading Legislation in the United States*, 39 Wash. & Lee L. Rev. 825, 831 (1982).

on which the grain offered for sale was grown, and the members of the exchanges on which cash sales of similar grain occurred and which had been designated contract markets.[295] Section 9 of the Grain Futures Act complemented this section by providing that "any one trading futures in violation of Section 4 or sending intentionally or carelessly false or misleading quotations or information as to the price of grain was guilty of a misdemeanor."[296]

Shortly after passage of the Grain Futures Act, the Department of Agriculture determined that its authority was lacking and that the act contained too many loopholes. Thus, in 1936, after Congress decided to regulate the New York Stock Exchange, Congress enacted the Commodity Exchange Act (CEA) to replace the Grain Futures Act.[297] Despite the immediacy of the effects of the Great Depression, Congress bifurcated the regulation of the securities and futures industries because the banking committees controlled securities matters and the agriculture committees controlled commodity exchanges and neither was willing to cede power.[298] This division of Congressional oversight persists today.

The CEA extended further federal regulation of commodities to include cotton, rice, mill feeds, butter, eggs, and Irish potatoes.[299] The CEA also required entities that accepted customer funds to execute orders and to segregate customer funds deposited for the purposes of margin, prohibited fictitious and fraudulent transactions, such as wash sales and accommodations trades, and banned all commodity option trading.[300]

Under the CEA, the Grain Futures Commission continued to consist of the Secretary of the Agriculture, the Secretary of Commerce, and the Attorney General, but became known as the Commodity Exchange Commission.[301] The Commodity Exchange Administration continued to be an agency within the Department of Agriculture.

Throughout the early 1940s, Congress amended the CEA to broaden the number of commodities subject to the CEA, adding various fats and oils, peanuts, and soybeans. During this period, the Commodity Exchange Administration also merged with a number of other agencies within the Department of Agriculture. In 1947, the organization responsible for administering the CEA was transferred to the Commodity Exchange Authority, an agency of the Department of Agriculture. This organizational structure continued until the mid 1970s.

---

[295] 7 U.S.C. § 4 (1922).

[296] *Id*. § 9.

[297] H.R. 6672 enacted as Pub. L. 74-675, 49 Stat. 1491 (codified as 7 U.S.C. § 1 (1936)).

[298] Jake Keaveny, *In Defense of Market Self-Regulation-An Analysis of the History of Futures Regulation and the Trend toward Demutualization*, 70 Brook. L. Rev. 1419, 1428 (2004).

[299] H.R. 6672 enacted as Pub. L. 74-675, 49 Stat. 1491 (codified as 7 U.S.C. § 1 (1936)).

[300] 7 U.S.C. §§ 4c, 4d(2) (1936).

[301] 7 U.S.C. § 2 (1936).

In 1974, Congress passed the Commodity Futures Trading Commission Act of 1974 ("the 1974 Act").[302] The 1974 Act, in part, was a reaction to a series of market manipulation scandals and overhauled the CEA by among other things, creating the CFTC – an independent agency outside the confines of the Department of Agriculture.

The 1974 Act followed lengthy hearings on all aspects of futures trading and substantially expanded the definition of "commodity" to include a number of additional items, such as sugar, gold, and Government National Mortgage Association ("GNMA") Certificates.[303] It also expanded the regulatory reach of the CEA to include individuals providing investment advice regarding commodities (commodity trading advisors), collective investment vehicles trading primarily in commodities (commodity pools and commodity pool operators), and the traders and sales representatives of futures commission merchants (associated persons).

The 1974 Act also vested the CFTC with "broad and pervasive powers," including the power to shut down markets and fix prices in response to so-called market emergencies.[304] It also increased criminal penalties for market manipulations from $10,000 to $100,000 and granted the CFTC the authority to impose civil penalties of up to $100,000 for each violation of the CEA.[305]

The 1974 Act also included a key provision offered as a floor amendment – a four-year "sunset" provision, which meant that in 1978 the CFTC's authority to receive and spend appropriated funds was due to expire. That sunset provision has required Congress to "reauthorize" the CFTC seven times since 1978, typically in four to five year increments, but at times shorter periods of time. Some of those reauthorizations have been contentious while others have been relatively routine.

In 1978, Congress passed the Futures Trading Act of 1978, which renewed the CFTC's regulatory authority for four years and required the CFTC to maintain communication with the SEC, the Department of the Treasury, and the Federal Reserve Board.[306]

In 1981, the CFTC granted registration to the National Futures Association (NFA), as a self-regulatory futures association and approved its articles, bylaws, and rules. This act significantly changed how federal derivatives regulation worked operationally, moving many of the front-line examination and enforcement to this new self-regulatory organization (SRO). The role of the NFA and importance of SROs generally within the CFTC's regulatory structure is discussed in greater detail below.

---

302 H.R. 13113 enacted as Pub. L. 93-463, 88 Stat. 1389 (codified as 7 U.S.C. § 1 (1974)).

303 Stassen, 39 Wash. & Lee L. Rev. at 839.

304 *Id*. at 833.

305 7 U.S.C. § 9 (1974).

306 H.R. 10285 enacted as Pub. L. 95-405, 92 Stat. 865 (codified as 7 U.S.C. § 1 (1978)).

Later in the same year, the CFTC and the SEC jointly announced a basic jurisdictional agreement (known as the Shad-Johnson Accord) on the regulatory responsibilities of each agency for a variety of financial instruments, including stock index futures.

In 1982, Congress passed the Futures Trading Act of 1982, which renewed the CFTC's mandate for four more years and clarified the CFTC's jurisdiction in a number of areas.[307] In particular, the act codified the Shad-Johnson Accord, which granted the CFTC jurisdiction over broad-based stock index futures and banned single-stock and narrow-based stock index futures. This accord played a key role as the basis for dividing the jurisdiction over the swaps and security-based swaps market in the creation and implementation of the Dodd-Frank Act.

In 1992, Congress reauthorized the CFTC for two years by passing the Futures Trading Practices Act of 1992.[308] This act expanded the CFTC's regulatory authority, by among other things, granting the CFTC authority to exempt over-the-counter (OTC) derivatives and other transactions from regulation. The following year, using this new authority, the CFTC exempted certain swap agreements from regulation, particularly energy products.

The CFTC, however, did not exempt many other types of OTC derivatives at that time. During the 1990s, the use of OTC derivatives with underlying assets that were financial in nature, particularly interest rate swaps, foreign exchange swaps, and credit default swaps, grew substantially. The growth in the use of these products did not go unnoticed. In 1999, then Chair of the CFTC, Brooksley Born, suggested publicly that these products had many similarities to regulated futures and should be treated accordingly. The staff of the CFTC drafted a concept release describing how these products might be treated and Chair Born stated that she intended to seek public comment on the proposal. Other regulators and officials, including senior officials at the SEC, Federal Reserve, and Treasury Department, however, believed the concept release to be overbroad, unnecessary, and ill-considered. These individuals criticized the concept release publicly and stated that they did not believe OTC derivatives should be subject to CFTC regulation as futures.

The following year, Congress enacted legislation that confirmed that these OTC derivatives were not off-exchange futures and that they were outside the scope of the CFTC's regulation, save for limited subjects. In December 2000, Congress passed and President Clinton signed into law the Commodity Futures Modernization Act of 2000 ("CFMA"), which provided "legal certainty" for these instruments and in addition, reauthorized the CFTC for another five years, and overhauled much of the structure of the CEA.[309] The CFMA created a framework of "core principles" that individual boards of trade were required to comply with to maintain their

---

[307] H.R. 5447 enacted as Pub. L. 97-444, 96 Stat. 2294 (codified as 7 U.S.C. § 1 (1982)).
[308] H.R. 707 enacted as Pub. L. 102-546, 106 Stat. 3590 (codified as 7 U.S.C. § 1 (1992)).
[309] H.R. 4577 enacted as Pub. L. 102-546, 114 Stat. 2763 (codified as 7 U.S.C. § 1 (2000)).

contract market designations.[310] This core principles regime served as the basis for the CFTC's "principles-based" regulatory regime. Among other things, the CFMA also clarified the CFTC's jurisdiction over retail foreign currency transactions and repealed the ban on the trading of single stock futures.

Following the passage of the CFMA, the use of OTC derivatives continued to grow. By 2008, the notional value of OTC derivatives issued outstanding worldwide exceeded $600 trillion, a figure between 15 and 20 times the size of the regulated futures market. Following the credit crisis of 2007-08, policymakers began to question the underpinnings of the CFMA and its general exemption of OTC derivatives from regulation. In the U.S., staff at the relevant congressional committees, at the Treasury Department, the CFTC, and at the other regulators began working on proposed legislation.

In July 2010, Congress passed and President Obama signed into law the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act"). Title VII of the Dodd-Frank Act amended the Commodity Exchange Act to establish a comprehensive regulatory framework for OTC derivatives, separating them into CFTC-regulated swaps and SEC-regulated security-based swaps. Under the Dodd-Frank Act, the CFTC was granted jurisdiction over the $450 trillion swap market and the SEC was granted jurisdiction over the $9 trillion security-based swap market. The law provided for the direct regulation of entities making markets in OTC derivatives and required that standardized contracts be cleared through central counterparties. It created standards for executing these transactions on organized trading platforms. In addition, it created a system for reporting these trades to central data repositories.

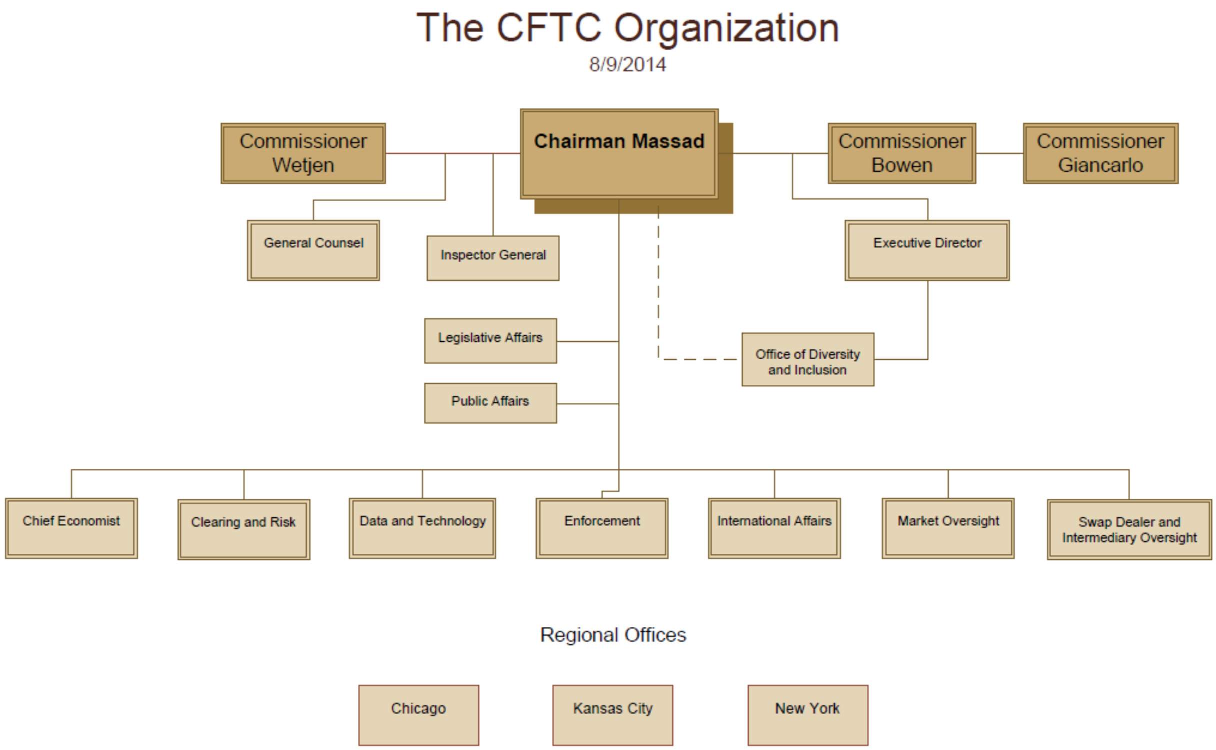
C. Commission Organization

The CFTC consists of five commissioners appointed by the President, and confirmed by the Senate, to serve staggered five-year terms. The President, with the consent of the Senate, designates one of the commissioners to serve as Chairman. No more than three commissioners at any one time may be from the same political party.[311] The Offices of the Chairman and Commissioners provide executive leadership and direction to the CFTC.

Nevertheless, much of the CFTC's authority flows through the Chairman directly rather than the Commissioners. For example, the chairman makes hiring decisions relating to senior staff members. Similarly, with the exception of the Office of the Executive Director, the Office of the General Counsel, and the Inspector General, division staff report to the Chairman not the

[310] 7 U.S.C. § 7(d)(1) (2000).
[311] 7 U.S.C. § 2(a)(2).

remaining Commissioners or the Commission generally.[312] Below is an organization chart for the CFTC:



Before proceeding to a discussion of the staff structure of the CFTC, and the manner in which the agency exercises its authority, this paper provides an overview of the markets and entities that the CFTC oversees.

D. Markets

The markets overseen by the CFTC over the course of its history have become increasingly multifaceted as CFTC regulation has shifted from an agricultural commodities focus, to include more varied and complex products including metals, energy, and particularly financial products. The distinctions between products largely arise from differences in product type and the nature of the underlying asset.

[312] 7 U.S.C. § 2(a)(4)-(5).

1. Product Types

a. Futures

The most basic and oldest form of a commodity contract regulated by the CFTC is a futures contract. Though the CEA does not specifically define what a futures contract is,[313] a futures contract is generally understood as a contract to buy or sell a commodity or financial product at a later date that is standardized and includes a right of offset, whereby a party can trade out of the obligation by entering an offsetting position. Futures are normally standardized according to the quality, quantity and delivery time, with the price as the only variable. The contracts are negotiated and subject to the rules of an exchange or similar registered entity[314] and cleared through a designated clearing organization (DCO or clearinghouse) which acts as an intermediary between the two parties. The party agreeing to buy the underlying asset in the future is the "buyer" and is said to be "long" and the party agreeing to sell the asset in the future is the "seller" and is said to be "short."

The clearinghouse is meant to minimize the risk of default and once the parties to a trade are matched through the exchange, their contracts are novated to the clearinghouse such that the clearinghouse serves as the counterparty to all parties. To reduce counterparty credit risk, the clearinghouse requires the parties to the futures contract to post margin, which will vary over time as the price of the future fluctuates over time; should the contract move against a party, that party will be required to post additional margin; should the contract move in favor of a party, its account will be credited with additional margin, with the clearinghouse serving as a pass through entity. This process is known as marking to market. Should the contract go all the way to delivery, the amount exchanged at settlement should be minimal because any gain or loss has already been transferred by the process of marking to market. Futures either can be physically-settled, where the short party must deliver and the long party must accept the actual physical commodity, or financially-settled, with the majority of contracts financially-settled.

---

313 There is a circuit split in the courts regarding what test to apply to determine whether a contract constitutes a futures contract. The "totality of the circumstances" multi-factor test, a test supported by the CFTC and established in *CFTC v. Co Petro Mktg. Grp., Inc.,* 680 F.2d 573 (9th Cir. 1982), applies the following factors: (1) whether the commodity underlying the transactions has inherent value to the defendant's customers; (2) whether the defendant's customers have the intention or capacity actually to receive the commodities being traded; (3) whether the contracts for the commodities are standardized and easily transferrable; and (4) whether, instead of waiting for the commodities to be delivered, the traders replace or "offset" the difference between the market price paid for the commodity and the current market price by buying a new commodities contract or by taking cash. *See, e.g., CFTC v. Erskine,* 512 F.3d 309, 316–18 (6th Cir. 2008) (describing a line of cases that applied the *Co Petro* multi-factor test). The "analysis stress test," established in *CFTC v. Zelener,* 373 F.3d 861, 865-66 (7th Cir. 2004), provides that—when trading in commodities futures—a "trade is 'in the contract'" as opposed to the actual commodity, when contract terms are standardized, the contracts are fungible, and it is "possible to close a position by buying an offsetting contract."
The CFTC has also had numerous opportunities to provide a clear definition of a future itself through administrative decisions or by

314 Such registered entities include both clearinghouse and DCMs, also referred to as "designated contract markets" and include boards of trade, derivate clearing organizations, swap execution facilities and electronic trading facilities, described in detail below.

Parties also trade variants on simple futures, including "spread contracts" which generally involve buying one futures contract and selling another futures contract with the purpose of profiting from an expected change in the relationship between the purchase price of one and the selling price of another. A myriad of more complicated spreads and futures exist, and the U.S. futures markets is estimated at between $30 and 40 trillion in notional value.[315]

In addition to futures, options have also been within the realm of contracts traditionally regulated by the CFTC (although actually banned from 1936 to 1981). The CEA defines an option in somewhat circular fashion, as "an agreement, contract, or transaction that is of the character of, or is commonly known to the trade as, an option, privilege, indemnity, bid, offer, put, call, advance guaranty, or decline guaranty."[316] Generally, an option contract gives the buyer the right, but not the obligation, to buy or sell the underlying asset at a specified price, also known as the "strike price" on or before a specified date.[317] The option which conveys the right to buy is referred to as a "call" and the option which conveys the right to sell is referred to as a "put."

b. Swaps

With the adoption of the Dodd-Frank Act, the CFTC's jurisdiction broadened to include the significantly larger swaps market. Today, by notional value, swaps are reported to be among the most heavily traded financial instruments in the world, amounting to an estimated $250 trillion in the U.S. market alone.[318] Generally, a swap is a derivative in which two counterparties exchange cash flows based on changes in the value of an underlying index or asset with a pre-agreed notional value. In other words, the parties agree to exchange cash flows, also called the "legs" of the swap. As an example, in a $1 million interest rate swap, one party pays a floating rate of interest against the $1 million and the other party pays a fixed rate of interest; as a matter of practically, the parties generally just exchange the difference. As opposed to a futures contract, swaps are significantly less standardized, allowing parties to customize duration, payment dates, nature of the underlying asset class, and termination terms. Many swaps, unlike futures are not cleared through a clearinghouse, leaving the parties' with credit exposure to each other.

The legal definition of a swap, as provided by the CEA, is quite complicated and very broad. Its breadth reflects its origin: The statutory text is actually drawn from another piece of legislation – the CFMA. As noted above, that statute was designed to exclude products from regulation as futures contracts and drafted with sufficient breadth in mind. In developing the

---

315 CFTC Annual Performance Report, FY 2015.

316 7 U.S.C. § 1a(36).

317 There are "American style" options and "European style" options. European style options can only be exercised at the end of an option's life, i.e. the maturity or expiration date. American options allow investor the opportunity to exercise the contract in the interim. Thus, European style options are often sold at a more discounted rate.

318 CFTC Annual Performance Report, FY 2015.

definition of "swap," the legislative drafting drew on the language used to create the exclusion in CFMA and the breadth of the original exclusion now forms the basis for the breadth of the CFTC's new jurisdiction.

The three prongs of the CEA's definition of "swap" potentially include things like insurance, home mortgage rate locks, and annuities.[319] The statute also enumerates certain products commonly understood as swaps.[320] As a practical matter, however, the CFTC, with the SEC, has interpreted the statute to exclude most common consumer and commercial financial products and focused instead on those products commonly thought of as swaps within the industry. Swaps excluded from the CEA definition by statute and thus, not regulated by the CFTC, also include those involving single securities, loans, and narrow-based indexes of securities which are instead regulated by the SEC[321] as well as forward sale contracts.[322][323]

Below is a summary of the relative size of the kinds of markets overseen by the CFTC. This chart includes exchanged traded instrument, OTC transactions in the U.S., as measured by the OCC, and OTC transactions globally, as measured by the Bank for International Settlement (BIS):

---

[319] 11 U.S.C. § 1a(47) provides that the term "swap" means any agreement, contract, or transaction— (i) that is a put, call, cap, floor, collar, or similar option of any kind that is for the purchase or sale, or based on the value, of 1 or more interest or other rates, currencies, commodities, securities, instruments of indebtedness, indices, quantitative measures, or other financial or economic interests or property of any kind; (ii) that provides for any purchase, sale, payment, or delivery (other than a dividend on an equity security) that is dependent on the occurrence, nonoccurrence, or the extent of the occurrence of an event or contingency associated with a potential financial, economic, or commercial consequence; (iii) that provides on an executory basis for the exchange, on a fixed or contingent basis, of 1 or more payments based on the value or level of 1 or more interest or other rates, currencies, commodities, securities, instruments of indebtedness, indices, quantitative measures, or other financial or economic interests or property of any kind, or any interest therein or based on the value thereof, and that transfers, as between the parties to the transaction, in whole or in part, the financial risk associated with a future change in any such value or level without also conveying a current or future direct or indirect ownership interest in an asset (including any enterprise or investment pool) or liability that incorporates the financial risk so transferred, including any agreement, contract, or transaction commonly known as— (I) an interest rate swap; (II) a rate floor; (III) a rate cap; (IV) a rate collar; (V) a cross-currency rate swap; (VI) a basis swap; (VII) a currency swap; (VIII) a foreign exchange swap; (IX) a total return swap; (X) an equity index swap; (XI) an equity swap; (XII) a debt index swap; (XIII) a debt swap; (XIV) a credit spread; (XV) a credit default swap; (XVI) a credit swap; (XVII) a weather swap; (XVIII) an energy swap; (XIX) a metal swap; (XX) an agricultural swap; (XXI) an emissions swap; and (XXII) a commodity swap; (iv) that is an agreement, contract, or transaction that is, or in the future becomes, commonly known to the trade as a swap; (v) including any security-based swap agreement which meets the definition of "swap agreement" as defined in section 206A of the Gramm-Leach-Bliley Act (15 U.S.C. 78c note) of which a material term is based on the price, yield, value, or volatility of any security or any group or index of securities, or any interest therein; or (vi) that is any combination or permutation of, or option on, any agreement, contract, or transaction described in any of clauses (i) through (v).

[320] 7 U.S.C. §1a(47)(A).

[321] 7 U.S.C. §1a(47)(B)(i).

[322] 7 U.S.C. § 1(a)(47)(B)(ii).

[323] Lastly, and in response to certain court decisions, the CEA has been amended to include within its regulatory jurisdiction certain retail products, many of which had a focus on foreign exchange products. Previously, several court decisions had excluded from CFTC jurisdiction certain products that had been marketed to retail customers. *See CFTC v. Zelner,* 373 F.3d 861 (7th Cir. 2004) (narrowly interpreting the term "contract of a sale of a commodity for future delivery" and holding that the transactions at issue were not subject to CFTC jurisdiction, based upon language in customer agreements); *see also CFTC v. Erskine,* 512 F.3d 309 (6th Cir. 2008). As part of the Dodd-Frank Act, the CEA was amended and now applies broadly to any agreement, contract, or transaction in any commodity that is entered into with, or offered to, a non-eligible contract participant or non-eligible commercial entity – effectively a retail customer on a leveraged, margined, or financed basis; and requires that such transactions be conducted on a regulated exchange and be subject to CFTC anti-fraud authority. 7 U.S.C. § 2(c)(2)(D)(i). The CFTC limits leverage in these contracts and imposes additional requirements that had largely been standard in the futures space. The section specifically exempts from its coverage those contracts where "actual delivery" is made within 28 days, or "such other longer period as the Commission may determine by rule or regulation based upon the typical commercial practice in cash or spot markets for the commodity involved." 78 FR 52426.

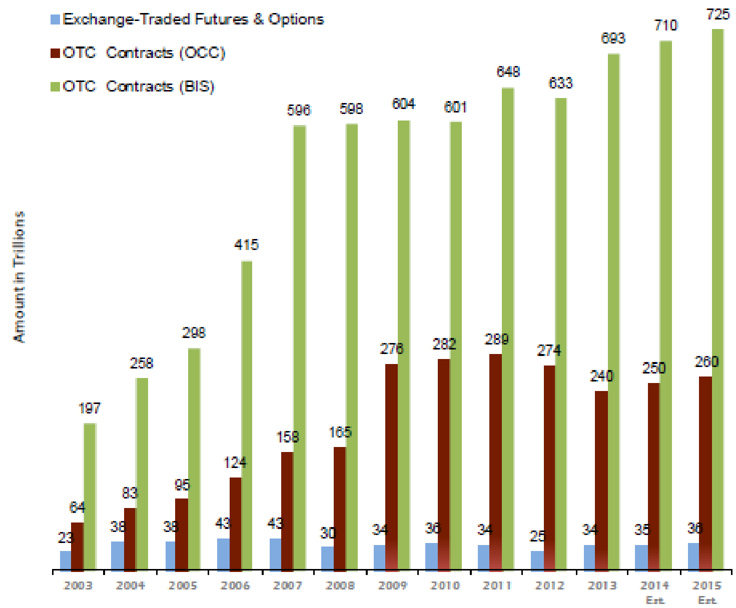


Figure 19: Notional Value of Exchange-Traded and OTC Contracts

2. Nature of the Underlying Asset

At a high level, over the last twenty years, derivatives markets in the U.S. have been dominated by financial products. While these markets may have originally developed to manage risks associated with physical commodities – agricultural products, metals, and energy, primarily – products related to interest rates, currencies and credits now represent approximately 90 percent of open interest. The below chart reflects the trend for futures and options contracts. The trend is even more pronounced in swaps:

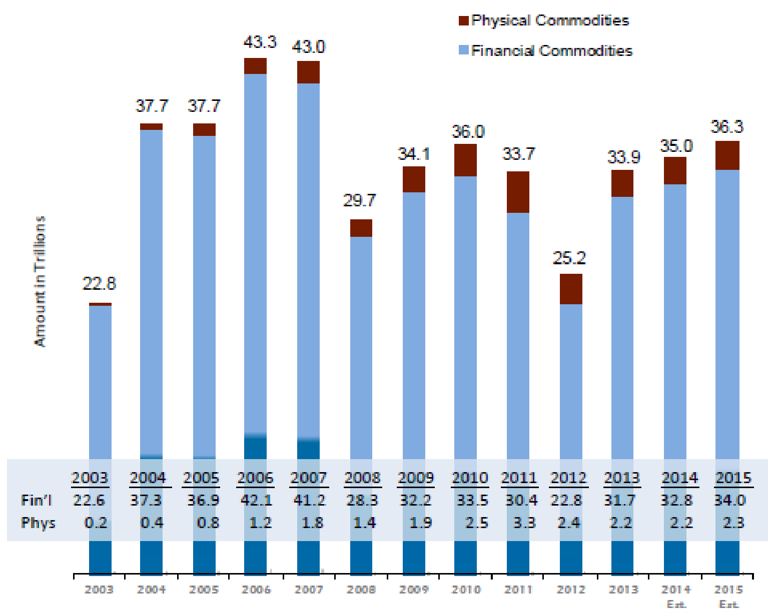


Figure 18: Notional Value of Futures and Option Open Contracts

These instruments, however, originally developed as agricultural products. Today, derivatives are written on numerous agricultural products from wheat, to frozen concentrated orange juice, to high protein whey. The Dodd-Frank Act broadened the definition of an agricultural commodity to include "[a]ll other organisms, including plant, animal and aquatic life, which are generally fungible, within their respective classes, and are used primarily for human food, shelter, animal feed, or natural fiber."[324] [325]

Metals are another long-time regulated underlying asset class and contracts based on these assets trade in significant volume. Contracts trade on both base and precious metals including gold, silver, copper, platinum, aluminum, and palladium. The rate of investments in metals and, in particular, gold, is often seen as indicative of market health. Such contracts are often rife for abuse and evasion of regulation. Accordingly, the CFTC has standing fraud advisories for consumers to "beware of promises of easy profits from buying precious metals" and to "use extra care when dealing with foreign companies."

In addition, CFTC regulated contracts include various underlying energy assets, including crude oil, natural gas and ethanol, as well as refined products. West Texas Intermediate crude oil (WTI), for years the world's most-traded commodity, is used as a benchmark in oil pricing in the

---

324 76 FR 41048 (July 13, 2011).

325 Not all farming-related products are regulated without controversy, however. For example, onions, which were added to the list of regulated commodities in 1955, were banned in 1958 in response to the alleged manipulation of certain onion futures contracts. The Onion Futures Act, banning onion futures, remains in effect to this day and violations are punishable by misdemeanor and a fine of not more than $5000. 7 U.S.C. § 13-1.

United States and is used as the underlying commodity of the Chicago Mercantile Exchange's oil futures contracts. Recently, the Brent futures contract, traded primarily on the ICE Futures Europe exchange, has become the global benchmark.

Swaps based on energy products were among the first to be officially sanctioned by the CFTC. In 1993, Congress issued an exemption from the exchange trading requirement for certain energy contracts that were traded between physical energy market participants, customized, and held to maturity and for the deferred purchase and sale of energy-related contracts, an exemption that was broadened by the Commodity Futures Modernization Act of 2000.[326] In 2008, however, Congress sought to close this exemption by enactment of the Commodity Futures Trading Commission Reauthorization Act of 2008. The original 1993 interpretation was withdrawn as part of the implementation of the Dodd-Frank Act as the new requirements supplanted the earlier interpretation.[327]

Energy contracts have been the subject of particular political scrutiny given the exposure that most Americans have to fluctuations in the price of gasoline or heating oil. Energy markets can be particularly volatile. This can be exacerbated by geopolitics. During and prior to the Persian Gulf War, the CFTC worked closely to the Department of Energy to guard against excessive speculation or manipulation in the crude oil markets. In 2005, pursuant to the Energy Policy Act of 2005, the CFTC and the Federal Energy Regulation Commission agreed to share information and proprietary energy trading data in light of energy market volatility.[328] In 2008, the CFTC created the Energy and Environmental Markets Advisory Committee to "advise the Commission on important new developments in energy and environmental futures markets that may raise new regulatory issues, and the appropriate regulatory response to ensure market integrity and competition, and protect consumers."[329] Changes in the price of energy products have continued to attract political attention in recent years and will likely do so in the future.[330]

Lastly, financial products are an area of recently increased regulation by the CFTC and represent the largest category of underlying asset for CFTC regulated instruments. The largest group of financial products are interest rate products, which allow parties to hedge, and speculate on, changes in interest rates. These include interest rate swaps, treasury futures contracts, Eurodollar contracts, and others. The CFTC also regulates broad-based credit products, primarily in the form of index credit default swaps (CDS). These products generally allow

---

[326] 58 Fed. Reg. 21,286; Pub. L. No. 106-554, 11 Stat. 2763.

[327] See CFTC Reauthorization Act of 2008, Pub. L. No. 110-246, 122 Stat. 1651, § 13201 (2008), codified at 7 U.S.C. § 2(a) (defining "significant price discovery contract").

[328] CFTC Press Release 5127-05.

[329] www.cftc.gov.

[330] *See, e.g.,* Letter from Sen. Bernie Sanders to President Barack Obama (June 4, 2012) (*available at* http://www.sanders.senate.gov/imo/media/doc/060412-ReplaceGensler.pdf); Letter from Sen. Bill Nelson to Gary Gensler, Chairman of the Commodity Futures Trading Commission (Mar. 16, 2011) (*available at* http://www.billnelson.senate.gov/newsroom/press-releases/effort-to-curb-oil-profiteering-gains-steam).

parties to hedge broadly the risk of default in corporate bond markets. Many are tailored to the variants in the corporate bond markets, with certain products focusing on investment grade debt and others on high-yield debt.

The CFTC also oversees products based on foreign exchange, but with some limitations. According to the BIS, trading in foreign exchange markets averaged $5.3 trillion per day in April 2013. Foreign exchange swaps were the most actively traded instruments, at $2.2 trillion per day, followed by spot trading at $2.0 trillion.[331] Most foreign exchange swaps, however, are exempt from the majority of CFTC regulations, including mandatory clearing and exchange trading. They are subject to certain business conduct standards and anti-fraud and anti-manipulation rules, as well as requirements that they be reported to data repositories.

3. The Growth of International Markets and Cross-border Transactions

Cross-border derivatives transactions have taken on greater importance in recent years as investment capital increasingly crosses borders and suppliers face needs to hedge currency and rate risk. The CFTC has engaged with its international counterparts for many years. The CFTC is a member in various international standard setting organizations such as IOSCO (International Organization of Securities Commissions) and the COSRA (Council of Securities Regulators of the Americas), and works regularly with many others. The CFTC also seeks to assist in the enforcement efforts of international counterparts, refer matters to foreign regulators pertaining to matters involving their jurisdictions, and offers and conducts training sessions for a number of foreign regulators and market authorities.

As CFTC regulated markets have grown over the years, the CFTC's international activities have taken on greater and greater importance. The international application of CFTC regulations, and how CFTC-regulated instruments are traded between entities in different jurisdictions became one of the more contentious topics among regulators in different jurisdictions during 2013 and 2014. Specifically, the swaps market has come to involve a greater proportion of cross-border transactions in part because of the global nature of the market and because the contracts are regularly bi-lateral – not cleared – and thus may involve exposures between entities in two different jurisdictions. The interplay between entities in two different jurisdictions assuming credit risk to one another and the Dodd-Frank Act's clearing and trading requirements create challenges in identifying where the authority of one jurisdiction ends and where the authority of the next jurisdiction begins.

Many market participants raised concerns that a broad understanding of the CFTC's cross-border jurisdiction had the potential to create conflicts with foreign regulators. They also raised concerns that cumbersome rules could inhibit the smooth transfer of risk and capital from one jurisdictions to another. Finally, these commentators noted that U.S. regulation was

[331] www.bis.org.

significantly farther along than regulation in other key jurisdictions and that it was critical that the CFTC adapt the timing of its implementation with that of other jurisdictions.

Other commentators, however, raised concerns that unless the CFTC adopted a very broad understanding of its jurisdiction, risk and trading would likely flow to the least well-regulated jurisdiction.

In part to address these concerns, the CFTC has promulgated guidance outlining how it expects to apply new rules to cross-border businesses.[332] The guidance has been the subject of significant controversy, including court challenge where it was recently upheld at the trial court level. At a high level, the guidance predicates jurisdiction on two factors – where certain activity occurs and the nationality of the market participants. Broadly speaking, if activity occurs within the U.S., it is subject to U.S. jurisdiction. In addition, if a transaction involves a "U.S. person" or a person "guaranteed" by a U.S. person, it will be subject to some form of U.S. regulation, with the theory being that the risk of the transaction flows back to U.S. regulated entities. The CFTC also adopted a system of "substituted compliance" whereby entities subject to U.S. rules can meet those requirements by complying with the rules in other jurisdictions which the CFTC deems to be "comparable." As noted, the guidance was the subject of a recent court challenge which resulted in the guidance being upheld, with the requirement that the CFTC conduct additional cost-benefit analysis concerning some particular rules.

Attention has since shifted to how market infrastructure, such as DCOs and trading platforms, will be able to access customers in other jurisdictions – how will foreign regulators treat U.S. entities and how will the CFTC treat foreign entities seeking to serve U.S. customers. The CFTC provides mechanisms by which market infrastructure in other jurisdiction can service U.S. clients; foreign boards of trade can register with the CFTC to allow U.S. customers access to their foreign markets. This allows the agency to oversee foreign products made available to U.S. customers and regulate who may offer and sell foreign products to U.S. customers (included within this regulation are entities with "Part 30 Exemptions," those who are subject to a comparable regulatory framework in the country in which they are located and have obtained exemption status from the CFTC). However, there remains a substantial and ongoing dispute, particularly with European regulators over whether U.S. and EU law are equivalent. Reconciling that issue will be necessary before entities in each jurisdiction will have unfettered access to customers in other markets.

4. Entities Overseen by the CFTC

Prior to the enactment of the Dodd-Frank Act, unregulated swap dealers and swaps activity represented a substantial gap in CFTC authority. The collapse of AIG Financial Products and the related stresses in the market for credit default swaps crystallized for many a glaring lack of oversight of swaps and swap dealers. The Dodd-Frank Act brought swap dealers

[332] 78 FR 45292 (July 26, 2013).

under CFTC jurisdiction, and applied to them certain risk management and business conduct requirements, as well as requirements to clear standardized swap transactions. This section outlines the key categories of regulated entities subject to CFTC oversight. It groups them among various functions, including clearing, execution, and managed funds, and then briefly summarizes groups of unregulated entities that have drawn attention in recent years.

a. Regulated Entities

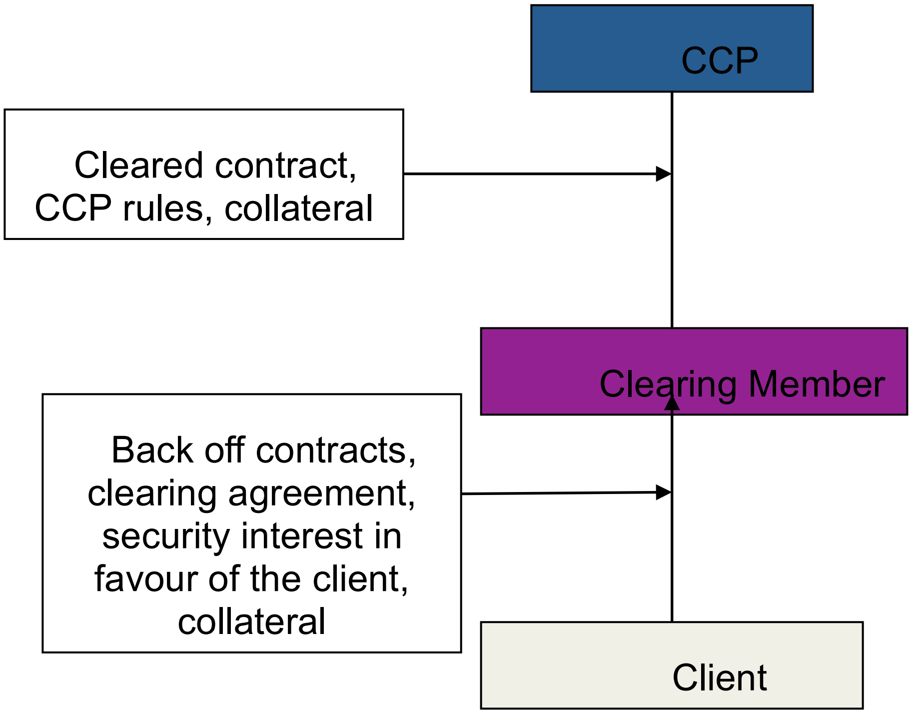
Prior to the enactment of the Dodd-Frank Act, many participants in the swaps markets were either completely unregulated, or not regulated for their swaps activities. In response, the Dodd-Frank Act created new categories of regulated entities and vested the CFTC with jurisdiction over a wide range of their activities. For example, the Dodd-Frank Act defined certain entities as swap dealers and major swap participants and required them to register with the CFTC, keep records, and meet certain risk-management requirements.[333] In addition, the Dodd-Frank Act created heightened requirements for existing regulated entities. The major categories of regulated entities subject to CFTC jurisdiction are summarized below.

b. Entities Related to the Clearing Process

As noted above, the clearing process is a fundamental element of derivatives markets. It creates a mechanism to mutualize credit risk among market participants and ensures, through margining, that parties do not take on more market risk than they can afford. In the U.S., this process happens through client clearing through which a limited number of firms are "members" of the DCO or central counterparty (CCP) and customers transact through these entities.

---

[333] *See* Dodd-Frank §§ 723, 729, 731; 7 U.S.C. §§ 2, 6.



Only the clearing members have actual exposure to the DCO/CCP and the clearing members collect margin from the customers, much of which they pass on to the DCO. The key entities in the clearing process are described further below.

5. Derivatives Clearing Organization

A DCO is a clearing organization or similar entity, registered with the CFTC that, with respect to a derivatives contract: (1) enables each party to the contract to substitute, through novation or otherwise, the credit of the DCO for the credit of the parties; (2) arranges or provides, on a multilateral basis, for the settlement or netting of obligations resulting from such contracts; or (3) otherwise provides clearing services or arrangements that mutualize or transfer among participants in the DCO the credit risk arising from such contracts.[334] One of the cornerstones of the Dodd-Frank Act is to require the clearing of many types of swaps through DCOs. Senate legislative history from the enactment of the Dodd-Frank Act described the clearing requirement as "a key element [for] reducing systemic risk and protecting taxpayers . . . and the financial system as a whole" from the failures that led to the financial crisis in 2008.[335]

[334] 7 U.S.C. § 1a(15)(A); *see also* CFTC Glossary: A Guide to the Language of the Futures Industry, *available at* http://www.cftc.gov/consumerprotection/educationcenter/cftcglossary/index.htm

[335] *See* S. Rep. 111-176, at 32 (Apr. 30, 2010).

A clearinghouse that seeks to provide clearing services with respect to futures, options, or swaps must register with the CFTC as a DCO before it can begin providing such services. To obtain and maintain registration, a DCO must comply with the DCO core principles established in Section 5b of the CEA, 7 U.S.C. § 7a-1.[336] This includes requiring a DCO to maintain records of all activities related to its business for a period of not less than five years, and to provide the CFTC with all information the CFTC deems necessary to oversee the DCO.[337] Title VII of the Dodd-Frank Act then requires that all swap transactions be cleared through a DCO if the CFTC has determined that the swap, or group, category, type or class of swap, is required to be cleared, unless an exception to the clearing requirement applies.[338] [339] Several DCOs have also been designated as systemic by the Financial Stability Oversight Council and are subject to heightened requirements.

Below is a list of the DCOs registered with the CFTC:

Derivatives Clearing Organizations		2008	2009	2010	2011	2012	**2013**
Cantor Clearinghouse L.P.	Cantor Clearinghouse			✓	✓	✓	✓
Chicago Board of Trade	CBOT	✓	✓	✓	✓	✓	
Clearing Corporation	CCorp	✓	✓	✓	✓	✓	✓
Chicago Mercantile Exchange, Inc.	CME Clearing House	✓	✓	✓	✓	✓	✓

[336] The core principles are: (1) adequate financial, operational, and managerial resources; (2) appropriate standards for participant and product eligibility; (3) adequate and appropriate risk management capabilities; (4) ability to complete settlements on a timely basis under varying circumstances; (5) standards and procedures to protect member and participant funds; (6) efficient and fair default rules and procedures; (7) adequate rule enforcement and dispute resolution procedures; (8) adequate and appropriate system safeguards, emergency procedures, and plan for disaster recovery; (9) obligation to provide necessary reports to allow the CFTC to oversee clearinghouse activities; (10) maintenance of all business records for five years in a form acceptable to the CFTC; (11) publication of clearinghouse rules and operating procedures; (12) participation in appropriate domestic and international information-sharing agreements; (13) avoidance of actions that are unreasonable restraints on trade or that impose anti-competitive burdens; (14) governance arrangements and fitness standards; (15) rules to minimize conflicts of interest in the DCO's decision-making process and process for resolving any conflicts; (16) composition of governing boards to include market participants; and (17) well founded legal framework for the activities of the DCO. 7 U.S.C. § 7a-1.

[337] *See* 7 U.S.C. § 7a-1(b)(J)-(K).

[338] *See* Clearing Requirement Determination Under Section (2)h of the CEA, 77 Fed. Reg. at 74285 (Dec. 31, 2012) (codified at 17 C.F.R. pts 39, 50).

[339] The CFTC will take into account the following factors when determining whether a swap should be subject to the mandatory clearing requirement:

- The existence of significant outstanding notional exposures, trading liquidity, and adequate pricing data;
- The availability of rule framework, capacity, operational expertise and resources, and credit support infrastructure to clear the contract on terms that are consistent with the material terms and trading conventions on which the contract is then traded;
- The effect on the mitigation of systemic risk, taking into account the size of the market for such contract and the resources of the DCO available to clear the contract;
- The effect on competition, including appropriate fees and charges applied to clearing; and
- The existence of reasonable legal certainty in the event of the insolvency of the relevant DCO or one or more of its clearing members with regard to the treatment of customer and swap counterparty positions, funds, and property.

17 C.F.R. § 39.5(b)(3)(ii).

Derivatives Clearing Organizations		2008	2009	2010	2011	2012	**2013**
Chicago Mercantile Exchange Europe Limited	CME Clearing Europe				✓	✓	
ICE Clear Credit LLC	ICE Clear Credit				✓	✓	✓
ICE Clear Europe Ltd	ICE Clear Europe			✓	✓	✓	✓
ICE Clear US, Inc.	ICE Clear US	✓	✓	✓	✓	✓	✓
Kansas City Board of Trade Clearing Corp	KCBT	✓	✓	✓	✓	✓	
London Clearing House Clearnet LLC.	LCH LLC		✓	✓	✓	✓	✓
London Clearing House Clearnet Ltd	LCH Ltd	✓	✓	✓	✓	✓	✓
Minneapolis Grain Exchange Inc.	MGE	✓	✓	✓	✓	✓	✓
Natural Gas Exchange Inc.	NGX		✓	✓	✓	✓	✓
New York Portfolio Clearing, LLC	NYPC				✓	✓	✓
North American Derivatives Exchange, Inc.	NADEX	✓	✓	✓	✓	✓	✓
NYMEX Clearing House	NYMEX	✓	✓	✓	✓	✓	
Options Clearing Corporation	OCC	✓	✓	✓	✓	✓	✓
TOTAL		10	12	14	17	17	13

a. Clearing Member

Clearing members are entities, usually banks and broker-dealers, through which customers interface with the DCO and which provide credit support to the DCO. Clearing members collect margin from customers, some of which they pass on to the DCOs and the rest of which they hold for customers in segregated accounts. All clearing members are futures commission merchants (described further below). Clearing members effectively guarantee the performance of customers who trade through them and thus analyze the credit of their clients and collect margin reflecting their creditworthiness. The following chart indicates the amount of margin clearing members have collected on behalf of clients that has been deposited with DCOs in recent years.

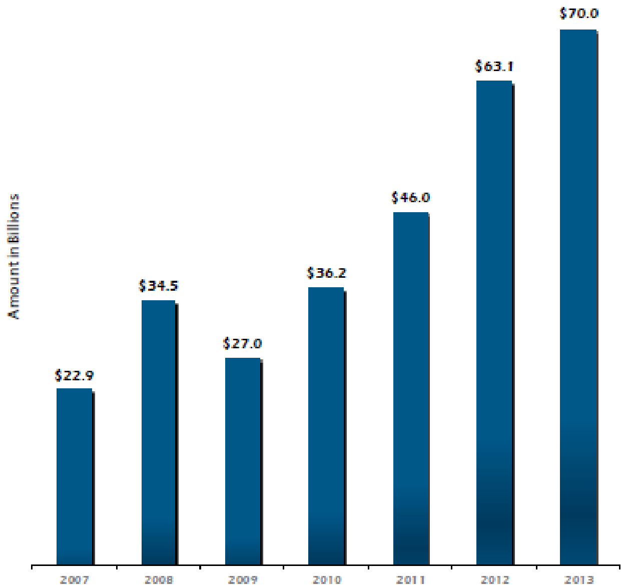


Figure 21: Aggregate Sum of House Origin Margin on Deposit

Clearing members are required to meet certain capital requirements and maintain certain risk management standards. They are subject to strict requirements about how they segregate customer funds from their own, many of which became the subject of scrutiny following the collapse of MF Global and its failure to maintain proper segregation of customer funds.

6. Futures Commission Merchant

A FCM is any entity or individual that solicits or accepts orders for (i) the purchase or sale of any commodity for future delivery, (ii) a security futures product, (iii) a swap, (iv) certain commodity transactions with persons that are not ECPs, (v) commodity options authorized under Section 4c of the CEA, (vi) or leverage transactions authorized under Section 19 of the CEA.[340] Effectively, FCMs are entities that accept and hold customer money to facilitate those customers entering into futures or swaps transactions. The CFTC has statutory authority to promulgate rules and regulations including or excluding individuals or entities from the definition of a FCM.[341]

Not all FCMs are clearing members. While FCMs may collect customer money, some actually clear through another entity rather than becoming a clearing member of DCOs themselves. Note, many entities are dually registered as FCMs and broker-dealers.

---

340 *See* 7 U.S.C. § 1a(28)(A).

341 *See* 7 U.S.C. § 1a(28)(B).

Any individual or entity that acts as a FCM must register as such under the CEA.[342] FCMs are required to meet minimum financial requirements, which are designed to protect commodity customers as well as the financial integrity of the futures markets as a whole by assuring that FCMs are sufficiently liquid to meet their obligations to customers and the marketplace.[343] These capital requirements parallel net liquid assets capital requirements that are applied to broker-dealers. FCMs, like clearing members, are also required to segregate commodity customer funds from propriety funds.[344] The following chart indicates the total amount of funds in FCM accounts.

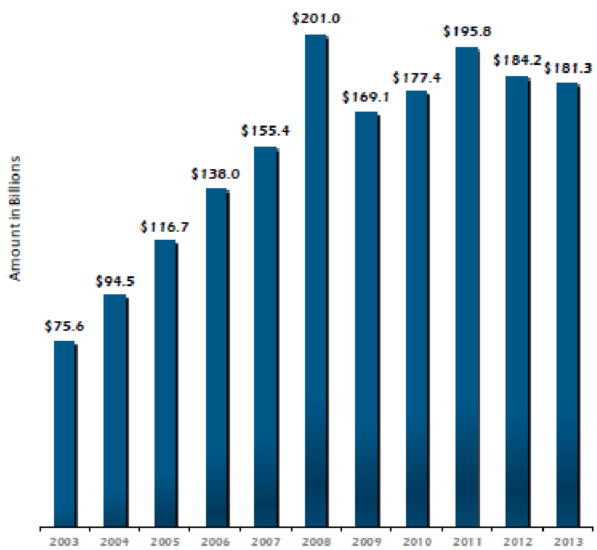


Figure 20: Customer Funds in FCM Accounts

7. Execution Platforms

Following Dodd-Frank, there are now two types of registered derivatives trading facilities under the CEA. *See* 7 U.S.C. § 7b-3(a).[345] Different requirements apply to each.

---

[342] *See* 7 U.S.C. § 6d(1); 17 C.F.R. §§ 32.3(a), 33.3(b).

[343] *See* 17 C.F.R. § 1.17; *see also* 6 Collier on Bankruptcy P. 760.04.

[344] *See* 17 C.F.R. § 1.20.

[345] Foreign Boards of Trade (FBOTs), trading platforms located abroad that wish to provide direct access to U.S. customers can also register with the CFTC. DCMs and SEFs, however, are the two primary forms of U.S. organized trading platforms.

a. Designated Contract Market

The first type is a designated contract market ("DCM"), which is a traditional derivatives trading facility. It is a board of trade or exchange designated by the CFTC to trade futures, swaps, and/or options under the CEA.[346] A DCM can allow both institutional and retail participants and can list trading contracts on any commodity, provided that each contract is not readily susceptible to manipulation.[347] The term "designated" simply means a contract market has been authorized by the CFTC to act as the market for particular derivatives contracts.[348] As indicated above, nonexempt swap transactions must be traded through either a registered DCM, or a registered swap execution facility ("SEF"). Individuals or entities who are not classified as Eligible Contract Participants (see below), however, may only trade on a DCM.[349]

A DCM is required to make public on a daily basis information on settlement prices, volume, open interests, and opening and closing ranges for actively traded contracts.[350] A DCM is also required to report to the CFTC for each business day (1) the total amount of all long and short open contracts, (2) the quantity of contracts bought and sold, (3) the quantity of purchases and sales of futures for commodities or for derivatives positions, and (4) for futures, the quantity of the commodity for which delivery notices have been issued and stopped.[351] Additionally, unlike a SEF, a DCM is only permitted to match trades using a central limit order book ("CLOB"), a market structure whereby bids and offers are matched exclusively based on their price and/or the time that they arrived at the market.[352]

Below is a list of the DCMs currently registered with the CFTC:

Derivatives Clearing Organizations		2008	2009	2010	2011	2012	**2013**
Cantor Clearinghouse L.P.	Cantor Clearinghouse			✓	✓	✓	✓
Chicago Board of Trade	CBOT	✓	✓	✓	✓	✓	
Clearing Corporation	CCorp	✓	✓	✓	✓	✓	✓
Chicago Mercantile Exchange , Inc.	CME Clearing House	✓	✓	✓	✓	✓	✓
Chicago Mercantile Exchange Europe Limited	CME Clearing Europe				✓	✓	
ICE Clear Credit LLC	ICE Clear Credit				✓	✓	✓

346 7 U.S.C. § 7 (a), (d); *see also* CFTC Glossary.

347 17 C.F.R. § 38.200.

348 6 Collier on Bankruptcy P. 760.04.

349 7 U.S.C. § 2(e).

350 17 C.F.R. § 38.450.

351 17 C.F.R. § 16.00(a).

352 *See* Core Principles and Other Requirements for Designated Contract Markets, 77 Fed. Reg. 36622 (June 19, 2012); *see also* CFTC Glossary.

Derivatives Clearing Organizations		2008	2009	2010	2011	2012	**2013**
ICE Clear Europe Ltd	ICE Clear Europe			✓	✓	✓	✓
ICE Clear US, Inc.	ICE Clear US	✓	✓	✓	✓	✓	✓
Kansas City Board of Trade Clearing Corp	KCBT	✓	✓	✓	✓	✓	
London Clearing House Clearnet LLC.	LCH LLC		✓	✓	✓	✓	✓
London Clearing House Clearnet Ltd	LCH Ltd	✓	✓	✓	✓	✓	✓
Minneapolis Grain Exchange Inc.	MGE	✓	✓	✓	✓	✓	✓
Natural Gas Exchange Inc.	NGX		✓	✓	✓	✓	✓
New York Portfolio Clearing, LLC	NYPC				✓	✓	✓
North American Derivatives Exchange, Inc.	NADEX	✓	✓	✓	✓	✓	✓
NYMEX Clearing House	NYMEX	✓	✓	✓	✓	✓	
Options Clearing Corporation	OCC	✓	✓	✓	✓	✓	✓
TOTAL		10	12	14	17	17	13

b. Swap Execution Facility

The second type of registered derivatives trading facility is a SEF, which is a trading system or platform created by the Dodd-Frank Act in which multiple participants have the ability to execute or trade swaps by accepting bids and offers made by multiple participants in the facility or system, through any means of interstate commerce.[353] Nonexempt swap transactions that are not traded on a DCM must be traded through a registered SEF.[354] However, only individuals or entities who are classified as Eligible Contract Participants are authorized to trade on a SEF.[355]

Unlike a DCM, which is only permitted to match trades using a CLOB, a SEF must have CLOB functionality, but may also match trades using a request for quote ("RFQ") system, a trading system or platform whereby market participants transmit a request for buy or sell prices for a specific instrument and transaction size to other market participants, similar to a competitive bidding process.[356]

Some DCMs and SEFs are vertically integrated with DCOs, while others are not. For example, the Chicago Mercantile Exchange is a DCM for numerous exchange-traded products, and is also registered as a DCO. The Chicago Mercantile Exchange also operates a SEF

353 7 U.S.C. § 1a(50); *see also* CFTC Glossary.
354 7 U.S.C. § 7b-(3)(a).
355 7 U.S.C. § 2(e).
356 *See* 17 C.F.R. § 37.9.

Further, some entities operate as both DCMs and SEFs. According to the CFTC, "while a board of trade that is a single corporate entity may operate both a DCM and a SEF, DCMs and SEFs have separate core principles and requirements, and any entity that operates both must separately meet the statutory and regulatory requirements of each facility."[357]

c. Swap Data Repository

Swap data repositories ("SDRs") are registered entities created by the Dodd-Frank Act that collect and maintain information or records with respect to transactions or positions in, or the terms and conditions of, swaps entered into by third parties for the purpose of providing a centralized recordkeeping facility for swaps.[358] Market participants are required to submit information concerning their trades to SDRs which are responsible for the analysis and maintenance of data related to swap transactions, and the transmission of that data to the CFTC. The SDR is responsible under the CEA to make the data publicly available "in such form and at such times as the Commission determines appropriate to enhance price discovery."[359]

Under the Dodd-Frank Act, all nonexempt swap transactions must be reported to a SDR "as soon as technologically practicable after such publicly reportable swap transaction is executed."[360] Typically only one party to the swap is required to report, and the reporting party is determined by regulation based on the counterparties' status (*i.e.*, whether one of the counterparties is a swap dealer, MSP, or end-user).[361] [362] Data concerning swaps must be transmitted to SDRs not only for swaps traded on a SEF or DCM, but for all swaps, including those traded bilaterally.[363] The SDR is required to keep the swap data "[t]hroughout the existence of the swap and for five years following final termination of the swap, during which time the records must be readily accessible by the [SDR] and available to the [CFTC] via real time electronic access."[364] Thereafter, the data must be kept for a period of at least ten additional years in archival storage, and must be retrievable by the SDR within three business days.[365] [366]

---

357 Core Principles and Other Requirements for Designated Contract Markets, 77 Fed. Reg. 36622 (June 19, 2012); *see also* 17 C.F.R. § 37.8.

358 *See* 7 U.S.C. § 1a(48); CFTC Glossary.

359 7 U.S.C. § 2(a)(13)(B).

360 17 C.F.R. § 43.3; *see also* 7 U.S.C. § 2(a)(13)(A).

361 Pursuant to 17 C.F.R. § 45.8, in general, (a) if only one counterparty is a swap dealer, the swap dealer shall be the reporting party; (b) if neither counterparty is a swap dealer, and only one counterparty is a MSP, the MSP shall be the reporting party; (c) if both counterparties are non-swap dealers / non-MSPs, and only one counterparty is a financial entity, the financial entity shall be the reporting party; and (d) if none of the counterparties meet the criteria in (a)-(c), above, the counterparties shall agree as to which party is the reporting party.

362 *See* 17 C.F.R. § 45.8.

363 *See* 7 U.S.C. § 2(13)(G).

364 17 C.F.R. § 45.2(g)(1).

365 *Id.* § 45.2(g)(2).

d. Swap Dealer

A swap dealer is effectively a market-maker in swaps.[367] A person may be designated by CFTC rules as a swap dealer for a single type or single class or category of swaps or activities, and considered not to be a swap dealer for other types, classes or categories of swaps or activities.[368] The CFTC requires that persons engaged in these activities register as swaps dealers after they have reached a "de minimis" threshold, meaning that the aggregate gross notional amount of the swaps, with certain exceptions, that the person enters into over the prior 12 months in connection with dealing activities exceeds a certain amount.[369] This threshold is currently set at $8 billion, as part of a phase-in period, but is slated to move back to $3 billion over time.[370] [371]

CFTC rules impose substantial requirements on swap dealers. For example, swap dealers are subject to rules concerning trade confirmation, portfolio reconciliation, portfolio compression, and trading relationship documentation.[372] In addition, CFTC regulations mandate that a swap dealer keep, among other things, daily trading records of all swap transactions in which it engages; position records that identify by product and counterparty each position held by the swap dealer and whether the position is long or short; records of all transactions cleared through a DCO or executed on a DCM or SEF; records of all data reported to a SDR; marking and sales materials related to its swaps business; and complete business records of all activities related to its swaps business, including comprehensive financial records.[373] It is also expected that the CFTC will complete capital and margining requirements in the near future.[374]

---

366 In January 2014, the CFTC announced the formation of an interdivisional staff working group to review certain swap transactions data reporting and recordkeeping provisions. The working group has been asked to: (1) identify and make recommendations to resolve reporting challenges, if any; (2) review industry compliance with reporting obligations; (3) consider data field standardization and consistency in reporting among market participants; (4) recommend additional reporting guidance or requirements, as appropriate; and (5) explore whether the agency should seek additional regulatory and technology improvements and data analysis expertise. CFTC Press Release 6837-14.

367 The CEA defines a swap dealer as any person who (1) holds itself out as a dealer in swaps, (2) makes a market in swaps, (3) regularly enters into swaps with counterparties as an ordinary course of business for its account, or (4) engages in any activity causing the person to be commonly known in the trade as a dealer or market maker in swaps. 7 U.S.C. § 1a(49)(A).

368 *Id.* § 1a(49)(B).

369 17 C.F.R. § 1.3(ggg).

370 *See id*.

371 There are a number of exclusions from the swap dealer definition. For example, excluded from the definition of swaps dealer is any insured depository, to the extent the depository offers to enter into a swap with a customer in connection with originating a loan with that customer. 7 U.S.C. § 1a(49)(A). The term swap dealer also "does not include a person that enters into swaps for such person's own account, either individually or in a fiduciary capacity, but not as a part of a regular business." *Id.* § 1a(49)(C). These exclusions are the subject of extensive regulatory treatment. *See, generally*, 17 C.F.R. § 1.3(ggg).

372 *See* 17 C.F.R. § 23.500-23.504.

373 *See* 17 C.F.R. § 23.201-23.202; *see also* 17 C.F.R. § 45.2(a)(4).

374 *See, e.g.*, Capital Requirements of Swap Dealers and MSPs, 76 Fed. Reg. 27802 (May 12, 2011); Margin Requirements for Uncleared Swaps for Swap Dealers and MSPs, 76 Fed. Reg. 23732 (May 12, 2011).

e. Major Swap Participant

A MSP is any person who is not a swap dealer but that has large swaps exposures.[375] A person may be designated as a MSP for one or more categories of swaps without being classified as a MSP for all classes of swaps.[376] Certain corporate financing entities are excluded from the definition of MSP.[377]

In general, many of the requirements that apply to swap dealers also apply to MSPs.[378]

f. Eligible Contract Participant

An Eligible Contract Participant (ECP) is an entity, such as a financial institution, insurance company, or commodity pool, that because of its regulated status or the amount it invests on a discretionary basis is permitted to engage in certain activities.[379 380] This classification permits ECPs to engage in transactions, such as trading on a SEF or entering into a bilateral swap trade, that are not generally available to non-ECPs, like retail customers.

g. Entities Related to Managed Funds

The CFTC has authority over certain types of entities related to pooled investment vehicle and managed investment funds. Most of these funds and their related investment advisors and managers are dually registered under both the CEA and corresponding SEC related statutes, such as the Investment Company Act and the Investment Advisors Act. The SEC requirements continue to be the primary ones for dually registered individuals and entities, but in recent years, the CFTC has revised some of the exemptions it provided for dually registered funds and individuals.[381]

---

[375] A MSP is any entity that is not a swap dealer and (1) "maintains a substantial position in swaps for any of the major swap categories" as determined by the CFTC, excluding (i) "positions held for hedging or mitigating commercial risk;" and (ii) "positions maintained by any employee benefit plan . . . for the primary purpose of hedging or mitigating any risk directly associated with the operation of the plan;" (2) "whose outstanding swaps create substantial counterparty exposure that could have serious adverse effects on the financial stability of the United States banking system or financial markets; or (3) "a financial entity that is highly leveraged relative to the amount of capital it holds and that is not subject to capital requirements established by an appropriate Federal banking agency," and "maintains a substantial position in outstanding swaps in any major swap category as determined by the Commission." 7 U.S.C. § 1a(33)(A).

[376] *Id.* § 1a(33)(C).

[377] an entity whose primary business is providing financing, and uses derivatives for the purpose of hedging underlying commercial risks related to interest rate and foreign currency exposures, 90 percent or more of which arise from financing that facilitates the purchase or lease of products, 90 percent or more of which are manufactured by the parent company or another subsidiary of the parent company. *Id.* § 1a(33)(D). I

[378] *See, e.g.*, 17 C.F.R. § 23.201; *see also e.g.*, 17 C.F.R. § 45.2(a)(4).

[379] *See* 7 U.S.C. § 1a(18).

[380] ECP status includes entities such as commodity pools, employee benefit plans, and broker dealers, and also includes an individual who has amounts invested on a discretionary basis, the aggregate of which is in excess of (i) $10,000,000; or (ii) $5,000,000 and who enters into the agreement, contract or transaction in order to manage the risk associated with an asset owned or liability incurred, or reasonably likely to be owned or incurred, by the individual. *See* 7 U.S.C. § 1a(18); 17 C.F.R. § 1.3(ggg).

[381] *See*, e.g., 17 C.F.R. § 4.13.

1) Commodity Trading Advisor

A commodity trading advisor (CTA) is a person who, for pay, regularly engages in the business of advising others as to the value of commodity futures or options or the advisability of trading in commodity futures or options, or issues analyses or reports concerning commodity futures or options. Managers at hedge funds or their advisors are often registered with the CFTC as either CTAs, or CPOs (see below).[382] Absent an exemption from registration, CTAs are required to register under the CEA,[383] and are subject to disclosure and book and recordkeeping requirements.[384]

2) Commodity Pool Operator

A CPO is a person engaged in a business similar to an investment trust or a syndicate and who solicits or accepts funds, securities, or property for the purpose of trading commodity futures contracts or commodity options.[385] The CPO either itself makes trading decisions on behalf of the pool or engages a CTA to do so. Managers at hedge funds or their advisors are often registered with the CFTC as CPOs or CTAs, though many operate under an exemption.[386] Like a CTA, absent an exemption from registration, CPOs are required to register under the CEA,[387] and are subject to disclosure and book and recordkeeping requirements.[388] As noted above, many investment advisors that otherwise would have had to have registered as CPOs were able to rely on an exception from CPO registration. The CFTC has subsequently narrowed that exception which has resulted in an increased number of registered CPOs and their associated persons.

Below is a summary of the number of registered entities in each key category:

[382] CFTC Glossary; *see also* 7 U.S.C. § 1a(12).
[383] 7 U.S.C. §§ 6m, 6n.
[384] 17 C.F.R. §§ 4.22-23.
[385] CFTC Glossary; *see also* 7 U.S.C. § 1a(11).
[386] *See* CFTC Glossary.
[387] 7 U.S.C. §§ 6m, 6n.
[388] 17 C.F.R. §§ 4.22-23.

Entity	Acronym	Number of Registered Entities/Registrants		
		FY 2013 Actuals	FY 2014 Assumption	FY 2015 Assumption
Trading Entities				
Designated Contract Market	**DCM**	19	22-25	22-25
Swap Execution Facility	**SE**	17	20-40	20-40
Foreign Board of Trade	**FBOT**	1	12	12
Clearing Entities				
Derivatives Clearing	**DC**	13	17	19
Clearing Member		191	195	195
Systemically Important DCO	**SIDCO**	2	No more than 4	No more than 4
Data Repositories				
Swap Data Repository	**SD**	3	5-7	5-7
Intermediaries				
Futures Commission Merchant	**FC**	105	95	95
Swap Dealer	**SD**	82	120	120
Major Swap Participant	**MS**	2	6	6
Managed Funds				
Commodity Trading Advisor	**CTA**	2,636	2,650	2,650
Commodity Pool Operator	**CP**	1,811	1,800	1,800

h. Unregulated Entities

Though the Dodd-Frank Act expanded the CFTC's jurisdiction and brought within its scope a number of previously un- and under-regulated entities, concerns remain, however, with respect to certain unregulated market participants. Focus has shifted from sell-side participants such as swap dealers to buy-side participants such as commodity pool operators, who are regulated and subject to registration requirements, either directly or as registered investment companies, but subject to little prudential or trading regulation. Thus, while they are regulated regarding how they deal with customer money, their capital levels, leverage, and other risk management standards are largely unfettered. In addition, unregulated proprietary traders, such as High Frequency Trading (HFT) firms have become subject of increasing scrutiny. In 2012, the CFTC established a new subcommittee of the Technology Advisory Committee, the Subcommittee on Automated and High Frequency Trading. With a focus on automated trading, the CFTC recognized that the "shift in terms of speed and volume has challenged the exchanges and the Commission's ability to ensure market integrity and safeguard against market misfires such as flash crashes."[389] Given the recent attention on high-frequency trading and its mounting propensity for market instability and manipulation, it is likely that the CFTC will continue to evaluate how best to oversee these entities.

i. Core Divisions of the CFTC

In addition to the divisions which report to the full Commission – the Office of the Executive Director (OED) and the Office of the General Counsel (OGC) – the CFTC is organized largely along functional lines with four divisions focused on the CFTC's core functions: Division of Clearing and Risk (DCR), Division of Market Oversight (DMO); Division of Enforcement (DOE); Division of Swap and Intermediary Oversight (DSIO).

The Office of the Executive Director (OED) directs the allocation of CFTC resources, and develops and implements management and administrative policy. OED includes the following subdivisions: Business Management and Planning, Counsel the Executive Director, Financial Management, Human Resources, Secretariat, Diversity and Inclusion, Consumer Outreach, and the Office of Proceedings.

The Office of the General Counsel (OCG) provides legal services and support to the CFTC and all of its programs. These services include: (1) engaging in defensive, appellate, and amicus curiae litigation; (2) assisting the CFTC in the performance of its adjudicatory functions; (3) providing legal advice and support for CFTC programs; and (4) drafting and assisting other divisions and offices in preparing CFTC regulations; (5) interpreting the CEA; (6) overseeing the CFTC's ethics program; and (7) providing advice on legislative and regulatory issues.

The Division of Clearing and Risk oversees designated clearing organizations (DCOs) and other market participants that may pose risk to the clearing process. It oversees the clearing related functions of futures commission merchants, swap dealers, major swap participants and reports on large traders. Its mandate primarily concerns the clearing of futures, options on futures, and swaps by DCOs. As part of this function, DCR examines systemically important DCOs at least once a year and conducts other monitoring and surveillance of DCOs.

The Division of Market Oversight oversees the derivative markets and is tasked with ensuring that those markets accurately reflect the forces of supply and demand for the underlying commodities or products and are free of disruptive activity. DMO also evaluates new products to ensure they are not susceptible to manipulation. DMO also houses the CFTC's market

[389] CFTC Press Release 6178-12, February 9, 2012.

surveillance unit, which monitors trading and regularly briefs the Commission on developments and trends in markets it oversees.

The Division of Enforcement investigates and prosecutes alleged violations of the CEA and CFTC regulations, such as allegations involving improper conduct related to commodity or derivatives trading on U.S. exchanges or the improper marketing and sale of commodities or derivatives products to the general public. DOE also investigates and prosecutes fraud, manipulation, and other abuses that threaten market integrity.

Lastly, the Division of Swap Intermediary Oversight oversees the registration and compliance of intermediaries and futures industry self-regulatory organizations (SROs), including U.S. derivative exchanges and the National Futures Association (NFA). DSIO also develops and implements rules concerning the business conduct and internal risk management of swap dealers and other intermediaries and will be responsible for developing and monitoring compliance with those regulations through a system of supervision in coordination with the NFA, the SRO for those entities.

8. Supporting Offices

These core divisions are partnered with and supported by several offices, which are somewhat smaller than full divisions and serve particular functions. These include: the Office of the Chief Economist (OCE); the Office of Data and Technology (ODT); the Office of International Affairs (OIA), the Office of Legislative Affairs (OLA), and the Office of Public Affairs (OPA). Additionally, the CFTC has created a Whistleblower Office (WBO) to administer its whistleblower award program.

OCE provides the CFTC with economic analysis, advice, and context. It conducts analysis and provides perspective on both current topics and long-term trends in the derivatives markets such as market structure and high-frequency trading. At times it has supported the DOE and the market surveillance staff with analysis of trading behavior. It also played a key role in analyzing the events of May 6, 2010, commonly referred to as the “Flash Crash.” Recently, the OCE has played a key role in performing cost benefit analyses of CFTC regulations and collaborates with staff in other Divisions to ensure that CFTC rules are well supported.

ODT is led by the Chief Information Officer and delivers technology services to the CFTC in various ways, including by providing support to oversight and market surveillance functions as well as enforcement and litigation support. Under the Dodd-Frank Act, the CFTC gained greater access to data concerning swaps transactions which must now must be reported to swaps data repositories (SDRs). ODT has played a key role in helping to standardize this data so that the CFTC can glean the greatest benefit from it. Also, in recent years the CFTC has made an effort to use technology to automate some if its market surveillance functions and ODT has worked with market surveillance staff to facilitate this effort.

OIA advises the CFTC regarding international regulatory initiatives, provides guidance regarding international issues, represents the CFTC in international organizations, and coordinates CFTC policy as it relates to policies and initiatives of major foreign jurisdictions, the Financial Stability Board, and the U.S. Treasury Department. As cross-border issues related to the implementation of derivatives market reforms have taken on greater importance, OIA has played a larger and larger role in coordinating the CFTC's efforts with foreign regulators.

OLA serves as the CFTC's liaison with Congress. The OLA coordinates the provision of reports, briefings, and informational materials to Congressional offices and testimony of agency officials before various Congressional Committees. It also monitors legislative activities that affect the CFTC's mission and work. Additionally, the OLA manages the CFTC's response to inquiries on behalf of constituents and other communications from the legislative branch.

OPA serves as the CFTC's liaison with the general public and the media. OPA issues press releases, maintains the CFTC's website, and engages the public through social media.

The WBO is a recent addition to the CFTC's structure. It arises from Section 748 of Dodd-Frank, which created CEA Section 23 to establish a whistleblower program that will pay awards based on collected monetary sanctions. In May of this past year, the WBO issued its first award, paying $240,000 to an individual who provided "specific, timely, and credible information" that led to the bringing of an enforcement action.[390]

a. Staffing Levels

For several years, almost uniformly across the board, the CFTC has requested significant increases in its staffing levels.[391] In conjunction with those requests, the CFTC has stated that it is understaffed within the terms of its mandate. The following chart outlines the CFTC's 2013 fiscal year staffing as baseline as well as the CFTC's 2015 fiscal year estimates.

	FY13 Actual		FY14 Actual		FY15 Estimate	
	FTE	$ (000)	FTE	$ (000)	FTE	$ (000)
Agency Direction	32	$5,832	22	$6,314	33	$7,263
Administrative Management & Support	79	18,846	77	18,277	82	18,793
Chief Economist	12	2,482	9	2,632	12	4,021
Clearing & Risk	59	14,002	56	15,011	66	22,717

390 CFTC, CFTC Issues First Whistleblower Award, May 20, 2014, available at http://www.cftc.gov/PressRoom/PressReleases/pr6933-14

391 The CFTC had total staff of 647 in 2014 fiscal year and requested an increase of 149 over its 2015 estimated staffing levels for a total staff of 895 for 2016 fiscal year.

Data & Technology	83	59,781	77	64,140	98	74,884
Enforcement	157	39,728	149	43,312	169	58,019
General Counsel	51	13,059	48	13,141	52	13,532
International Affairs	10	2,662	12	3,190	12	3,160
Inspector General	5	1,473	6	2,028	7	2,574
Market Oversight	116	26,397	110	26,722	121	43,082
Swap Dealer & Intermediary Oversight	78	17,467	81	20,233	94	31,955
Total	**682**	**$201,729**	**647**	**$215,000**	**746**	**$280,000**

Summary of FY 2013 to 2015 by Division

Additionally, over last few years, the CFTC's budgets have included restrictions requiring the CFTC to spend approximately $50 million, or 25 percent, of its budget on technology. The CFTC has regularly acknowledged the need to increase its technology spending, but questions whether it can efficiently spend that figure in a given year. Further, the restrictions limit the CFTC's ability to make parallel investments in needed human capital. These restrictions have limited the CFTC's ability to grow itself. A number of observers have argued that the lifting of these restrictions would relieve greatly some of the pressures created by the CFTC's staffing and budgeting woes.

	FY13 Actual $ (000)	FY14 Actual $ (000)	FY15 Estimate $ (000)
Salaries and Expenses	$159,589	$181,171	$198,000
Information Technology	42,140	35,000	51,100
Total	**$201,729**	**$216,171**	**$250,000**

Summary of FY 2013 to 2015 by Program

E. Exercise of the CFTC's authorities

1. Rule Making Process and Constraints

Under the CEA, the CFTC has authority "to promulgate such rules and regulations as it deems necessary to govern the operating procedures and conduct of the business of the Commission."[392] Typically a new rule will start with the Chairman's office, which will oversee the entire process from proposal to issuance of final rules. As a result, the Chairman's office has

[392] 7 U.S.C. § 2(a)(12).

an ability to set the agenda for the CFTC's rulemaking and to influence the manner in which the CFTC considers various issues. He or she also has an effective veto as he or she can always choose not to submit a proposal to a vote.

a. Process

Typically, the CFTC's decision to take regulatory action stems from new legislation, such as the passage of the Dodd-Frank Act, or a change in a market practice or product that suggests the need for a new rule, such as the proliferation of high-frequency trading. When changes of this nature occur, typically the Chairman will request that the staff of a particular Division or Divisions prepare a draft recommendation. For example, if the matter prompting potential regulatory action relates to clearinghouse risk management, the Chairman will ask staff from the Division of Clearing and Risk for a recommendation; if the matter prompting potential regulatory action relates to disruptive trading practices, the Chairman will ask staff from the Division of Market Oversight for a recommendation.

The Division staff conducts research and meets with industry participants to solicit their feedback on potential regulatory action. The Division staff may also solicit feedback from the Commissioners regarding potential regulatory action (although the staff does not always do so at this early stage).

During the implementation of the Dodd-Frank Act and its rules, the Division staff would typically generate a "term sheet," a high-level summary of the staff's recommendations regarding the proposed rule. The staff sends the term sheet to the Chairman for his or her feedback and may exchange several drafts of the term sheet with the Chairman until he or she approves it. The staff then circulates the approved term sheet to the full Commission for its feedback.

After getting feedback from the Commissioners, the Division staff will use the term sheet to draft a Notice of Proposed Rulemaking (NPRM). The NPRM can range from as few as 30 to as many as 300 pages, depending on the complexity of the proposed rule. The NPRM explains why the CFTC believes a rule is necessary, identifies the CFTC's statutory authority for implementing such a rule, and outlines how the proposed rule would function. The NPRM also includes an analysis of how the benefits of the proposed rule outweigh its costs, and addresses additional administrative law requirements.

As with the term sheet, the staff first sends the NPRM to the Chairman for feedback and approval. Once approved by the Chairman, the staff circulates the NPRM to the full Commission for comments. The staff and Chairman work together to determine if and how the Commissioners' comments will be integrated into a revised NPRM. The revised NPRM is then approved by Chairman and voted on by the Commission.

Following the Commission's approval of the NPRM, the CFTC publishes the proposed rule in the Federal Register and requests public comments, generally over at least 60 days. At the conclusion of the comment period, the Division staff summarizes the comments and shares the summaries with the Chairman and Commissioners. The Chairman and Commissioners provide the staff with feedback on how to respond to the comments, and a similar process ensues where the staff works with the Chairman to create a draft Final Rule. Once approved by the Chairman, the staff circulates the draft Final Rule to the Commissioners, who often again provide feedback and the staff works with the Chairman to determine which comments to accept or reject, consistent with the need to secure the votes of a majority of the Commission. Ultimately, the Chairman approves a draft Final Rule and the Commission votes on it. If the Commission approves the draft, a Final Rule is published and the rule is implemented.[393]

1) Cost-Benefit Analysis and Other Administrative Requirements

The CFTC's rulemaking authority, however, is bounded by a number of administrative requirements which can slow the rulemaking process and open CFTC rulemakings to a variety of judicial challenges. Over the last several years, these administrative requirements have had significant impact on the manner in which in the CFTC has promulgated rules to implement the Dodd-Frank Act.

2) CEA Requirements

The CFTC's rulemaking authority has only been subject to explicit cost-benefit analysis requirements for a little over ten years. As part of the CFMA in 2000, Congress amended the Commodity Exchange Act to add new section 15(a).[394] In particular, that section requires that, "[b]efore promulgating a regulation under this Act or issuing an order … the [CFTC] shall consider the costs and benefits of the action of the Commission."[395] Further, the CEA provides that the CFTC's cost- benefit analysis should include considerations of: (1) the public good and the protection of market participants; (2) efficiency, competiveness, and the financial integrity of futures markets; (3) price discovery; (4) the importance of sound risk-management techniques; and (5) other public interest considerations.[396] [397]

---

[393] In addition to rulemaking, CFTC staff issues written guidance concerning the CEA and CFTC rules in the form of responses to requests for exemptive relief, no-action letters, and interpretations of rules. CFTC rule 140.99, codified at 17 CFR § 140.99, defines three types of staff letters that differ in terms of scope and effect: (1) exemptive letters; (2) no-action letters; and (3) interpretative letters.

[394] 7 U.S.C. 19.

[395] 7 U.S.C. 19(a)(1).

[396] 7 U.S.C. 19(a)(2).

[397] The CFTC's cost-benefit requirement differs somewhat from the requirement that applies to the SEC's rulemaking authority. Specifically, section 3(f) of the Securities Exchange Act requires that, in a rulemaking or when reviewing SRO rulemaking, the SEC must determine whether "an action is necessary or appropriate in the public interest" and whether it "will promote efficiency, competition and capital formation." 15 U.S.C. 78c(f).

Several other administrative requirements also impact the CFTC's rulemaking authority. In particular, the Administrative Procedures Act (APA), the Paperwork Reduction Act (PRA), and the Regulatory Flexibility Act (Reg-Flex) all require the CFTC to address certain issues and make certain determinations as part of their rulemakings.

2. Administrative Procedures Act

Congress passed the APA in 1946, among other reasons, to dictate uniform standards for formal rulemaking and adjudication and to outline judicial review of federal agencies. Under the APA, a court may vacate a rule if they find the rulemaking process "arbitrary and capricious, an abuse of discretion, or otherwise not in accordance with the law." Frequently, challenges under the APA subsume challenges based on cost-benefit grounds, and also include allegations that an agency did not provide sufficient justification for its actions, or that an agency failed to consider certain comments submitted during the rulemaking process.

3. Regulatory Flexibility Act

Congress enacted the Reg-Flex on September 19, 1980. Specifically, Reg-Flex requires agencies to prepare and release for comment an analysis that identifies why the agency is acting, its objectives, an estimate of the number of small entities likely to be affected, and any federal rules that may "duplicate, overlap or conflict with the proposed rule." The agency must also identify changes to the proposal made in response to comments received from the public. Reg-Flex also requires agencies to describe significant alternatives to the final rule, explain the economic impact of each on small entities, and explain why the agency rejected the alternatives in favor of the final rule.[398]

4. Paperwork Reduction Act

The PRA was also enacted in 1980 and created the Office of Information and Regulatory Affairs (OIRA) within the Office of Management and Budget (OMB). With respect to agency rulemaking in particular, the PRA requires agencies in their proposed and final rulemakings to identify whether a new rule or regulation will lead to an increase in the collection of information from private sector entities and to estimate the burdens associated with that information collection.

5. Executive Orders

While independent regulators are not subject to executive orders, their issuance can impact how rules are promulgated. Congressional oversight committees frequently seek information concerning how agencies' processes compare to the requirements detailed in

[398] Reg-Flex also requires agencies to periodically review rules that have or will have a "significant economic impact upon a substantial number of small entities."

executive orders. These requests can take the form of letters from members, questions for the record, or congressional hearings. In each case, while executive orders may not be directly applicable, they serve as a political basis to limit agency discretion in rulemaking.

Five executive orders in particular have had significant impact on agency rulemaking. First, on February 17, 1981, President Reagan issued Executive Order 12291 which, among other things, required that "[a]dministrative decisions shall be based on adequate information concerning the need for and consequences of proposed government action; [and r]egulatory action shall not be undertaken unless the potential benefits to society from the regulation outweigh the potential costs to society."[399] In 1994, President Clinton issued Executive Order 12866, which required that agencies "design [their] regulations in the most cost-effective manner to achieve the regulatory objective" and only to propose or adopt a regulation "upon a reasoned determination that the benefits of the intended regulation justify its costs."[400] Importantly, Executive Order 12866 explicitly required agencies to consider also "qualitative" factors in assessing cost-benefit considerations. President George W. Bush extended Executive Order 12866 to cover not only legislative rulemakings, but guidance documents as well in Executive Order 13422, issued on January 18, 2007.

President Obama has issued two executive orders with significant impact on rulemaking. First, he issued Executive Order 13563 on January 18, 2011 to reaffirm the "principles, structures, and definitions governing contemporary regulatory review that were established in [Clinton's] Executive Order 12866." The Order directed agencies to use the best available techniques to quantify anticipated present and future benefits and costs as accurately as possible. Agencies were specifically permitted to consider (and discuss qualitatively) values that are difficult or impossible to quantify, including equity, human dignity, fairness, and distributive impacts. Second, on July 11, 2011, President Obama issued Executive Order 13,579, which asked that independent regulatory agencies adopt "new steps to ensure smart, cost-effective regulations, designed to promote economic growth and job creation." While this Order was not binding on independent regulators, it created significant political pressure on regulators and was the subject of a number of congressional hearings.

a. Impact on CFTC Rulemaking

Taken together, cost-benefit analysis and other administrative requirements have become major factors in the way the CFTC promulgates rules and in the way industry participants participate in the rulemaking process. At the CFTC, in response to heightened attention on many of these requirements, rule issuance, both at the proposed and final rule stage, the agency has implemented a number of steps to improve its processes and to limit the potential for judicial challenges. For example, rulemaking teams must include members of the Office of the Chief

---

399 3 C.F.R. 127.

400 3 C.F.R. 638.

Economist and that office must sign off on all rules. In addition, the Office of the General Counsel conducts a particularized review of these administrative considerations. Because all rules must go through these two processes, both functions can act as bottlenecks for agency action.

Cost-benefit analysis and these other administrative requirements have also become the bases by which market participants challenge CFTC rulemakings judicially. No court has yet determined that the CFTC's cost-benefit analysis in a particular rule was deficient. However, a number of challenges likely to be decided in the near future may expand the scope of agency actions subject to cost-benefit analysis, which as a practical matter, may serve to limit agency discretion.

F. Enforcement, Oversight and Supervision

The Commission staff handles day-to-day market-related supervisory issues, including regular audits of larger firms and review of filings by registered entities. These functions could include things like ensuring that entities have sufficient capital to meet CFTC requirements or reviewing policies and procedures to ensure that swap dealers are complying with new business conduct requirements. Significant events – such as MF Global's failure to segregate sufficient funds, or the market events of May 6, 2010, typically referred to as the Flash Crash – are often elevated quickly and handled by the division staff in conjunction with the Chairman and his staff. The Chairman generally does not involve the Commission in the first instance, but will consult the Commission if the Chairman determines a rule change, enforcement action, or other actions that require Commission involvement are necessary.

In addition to these roles, as part of the CFTC's supervisory functions, the CFTC staff prepares and delivers regular reports on market activity, including the Commitments of Traders (COT) report, and the relatively new CFTC Swaps Report, which aggregates a comprehensive body of swap market data that was not previously reported to regulators or regulated entities.[401] Additionally, Dodd-Frank requires the CFTC to publish a report on trading, clearing, participants, and products in the swaps market on a semiannual and annual basis.[402] The Surveillance staff also meets with the Commission weekly to discuss market conditions and recent events.

1. Enforcement

The CFTC's enforcement authority is derived from the CEA.[403] Federal regulations delegate to the DOE the authority to "conduct such investigations as [it] deems appropriate to

---

401 http://www.cftc.gov/MarketReports/SwapsReports/index.htm

402 CEA § 2(a)(14).

403 CEA § 6c(a), 7 U.S.C. § 13a-1(a).

determine whether any persons have violated, are violating, or are about to violate the provisions of the Commodity Exchange Act, as amended, or the rules, regulations or orders adopted by the Commission pursuant to that Act."[404] As part of the investigation process, the DOE "may obtain evidence through voluntary statements and submissions, through exercise of inspection powers over boards of trade, reporting traders, and persons required by law to register with the Commission, or when authorized by order of the Commission, through the issuance of subpoenas."[405] The DOE reports "the results of [its] investigations and recommend[s] to the Commission such enforcement action as he deems appropriate"[406]

Significantly, although the CFTC, and by extension the DOE, has historically been vested with broad powers to prosecute market manipulation, prior to the Dodd-Frank Act, the burden was on the CFTC to prove that a defendant in an enforcement action acted with the specific intent to manipulate the market. Dodd-Frank Section 753 amended the CEA by adding a fraud-based manipulation provision modeled on Section 10(b) of the Securities Exchange Act of 1934. In implementing Section 753, the CFTC adopted Rule 180.1,[407] which is based on SEC Rule 10b-5 and which lowers the burden of proof from specific intent to recklessness in certain circumstances. This rule has yet to be tested in court and there are those commentators who question whether an individual can "recklessly" manipulate a market.[408]

a. Tips, Surveillance, and Origins of Enforcement Actions

DOE investigations arise based on information it develops independently, as well as information provided by a variety of other sources, including other CFTC Divisions, government agencies, SROs, Exchanges, and industry members. For example, the DOE may initiate an investigation based on market surveillance data it receives from the DMO that evidences unusual trading activity in a particular product or products either right before the close of the market, before the release of key market-moving data, or at another relevant moment, that may be indicative of improper activity. The DOE may also receive tips regarding potential market manipulation or other misconduct from other federal, state, and foreign government agencies,

---

404 17 C.F.R. § 11.2.

405 *Id.*

406 *Id.*

407 Rule 180.1 makes it unlawful to: (1) employ any "manipulative device, scheme or artifice to defraud;" (2) make or attempt to make, "any untrue or misleading statement of materials fact or to omit to state a material fact necessary in order to make the statements made not untrue or misleading;" (3) engage in any "act, practice, or course of business, which operates or would operate as a fraud or deceit upon any person;" or (4) deliver a "false or misleading or inaccurate report concerning crop or market information." 17 C.F.R. § 180.1(a).

408 Some industry members have expressed concern that Rule 180.1, as enacted, could be interpreted to impose new duties of disclosure, inquiry, or diligence on market participants. These industry members argue the lower recklessness standard for violations of SEC Rule 10b-5 may make sense in the context of the securities markets, where there are extensive disclosure obligations, but a similar standard as set forth in CFTC Rule 180.1 is problematic for commodities transactions because nothing in the CEA mandates the disclosures of market conditions or facts pertaining to the commodities markets. *See* Prohibition on Manipulative and Deceptive Devices and Price Manipulation, 76 Fed. Reg. 41402 (July 14, 2011). The CFTC has responded to this criticism by stating that Rule 180.1 does not impose any new affirmative duties of inquiry, diligence, or disclosure on market participants, and should not create any uncertainty as to the existence of disclosure obligations when applied to the commodities markets. *See id.*

such as the SEC, Department of Justice, New York States Attorney General's office, or the United Kingdom's Financial Conduct Authority. SROs, such as Atlanta-based ICE and Chicago-based CME Group, also provide investigative leads to the DOE, as do other CFTC members. The CFTC also investigates consumer complaints.

Additionally, the Dodd-Frank Act created a whistleblower program that has resulted in a number of high-value leads for the DOE.[409] The whistleblower program provides monetary awards to persons who report violations of the CEA, if the information leads to an action that results in more than $1 million in monetary sanctions. The whistleblower is eligible for 10 to 30 percent of the monies collected. The CFTC issued its first award to a whistleblower in May 2014, in the amount of approximately $240,000.[410] The DOE reports that it received 138 tips from whistleblowers in 2013, up from 58 tips in 2012.[411]

b. Investigative Process

When conducting an investigation, the DOE typically first seeks to gather information through informal methods, such as by sending inquires to member firms or traders to obtain voluntary statements and data. The DOE conducts these investigative activities prior to the issuance of a formal order of investigation or subpoena.

Historically, the DOE did not have formal order authority, and was required to obtain the Commission's approval before issuing a formal order of investigation or a subpoena related to an investigation.[412] Obtaining Commission approval usually required DOE staff to prepare a memorandum for the Commission containing a summary of the case and any possible violations, and recommending issuance of the order. This authority was generally, but not always, granted without any difficulty. It was, however, a time consuming process.

The DOE's lack of formal order authority was perceived by many as a bureaucratic obstacle that limited the DOE's ability to efficiently investigate potential misconduct. The DOE's lack of formal order authority also stood in stark contrast to the powers of the SEC's Enforcement Division, which obtained from the SEC Commission the authority to issue formal orders of investigation in 2009.[413]

As a result, in 2013, the CFTC Commission delegated formal order authority to the Director of the DOE. The DOE may now issue formal investigation orders and take

---

409 *See* 7 U.S.C. § 26; 17 C.F.R. § 165.

410 CFTC Press Release 6933-14.

411 CFTC Annual Report on the Whistleblower Program & Customer Education Initiatives (2013).

412 17 C.F.R. § 11.2 states that the DOE "may obtain evidence through voluntary statements and submissions . . . *or when authorized by order of the Commission, through the issuance of subpoenas*."

413 *See* 17 C.F.R. § 200.30-4.

investigative action—including subpoenaing witnesses and records—without the Commission's prior approval.[414] This brings the DOE's enforcement authority in line with the enforcement powers of the SEC Enforcement Division.

The DOE is not, however, authorized to bring charges against the subject of an investigation without Commission approval. This process requires the DOE to prepare a memorandum for the Commission containing a summary of the case and any possible violations, and recommending the issuance of formal charges. The Commission then votes on the DOE's charge recommendation.

If the Commission approves the charges, the DOE typically institutes an action on behalf of the CFTC in federal court. In general, the DOE prefers to bring cases in federal court, and does not typically initiate administrative proceedings. However, the CFTC has indicated an inclination to begin using the administrative forum.[415] The DOE may seek civil monetary penalties, orders of restitution, disgorgement of alleged ill gotten gains, or injunctive or other relief, including a temporary restraining order or preliminary injunction to halt perceived ongoing violations. The case will then proceed as any other federal litigation matter. In general, the DOE prefers to bring cases in federal court, and does not typically initiate administrative proceedings.

After bringing formal charges, the DOE is not authorized to settle a case without Commission approval. The DOE also may not appeal the final decision in a case without Commission approval.

2. The Role of SROs

The CFTC is responsible for supervising, among other groups, DCOs, SDs, DCMs, SEFs, SDRs, FCMs, CPOs, and other intermediaries. Much of these functions are delegated to self-regulatory organizations (SROs), which the CFTC then audits on a regular basis. The National Futures Association is the largest SRO and oversees swap dealers, FCMs, CTA, and IBs, among others. The role of SROs is detailed further below.

According to the CFTC, "[f]or the overwhelming number of market participants, the Commission's role is as a second-line regulator, where the agency relies on the [self-regulatory organizations (SROs)] to perform critical regulatory responsibilities."[416] These participants include SDs, FCMs, IBs, CTAs, and CPOs, which are primarily overseen by the NFA. In

---

414 *See* Commissioner Scott O'Malia, Dissenting Statement to the Division of Enforcement's Request that the Commission Issue the Omnibus Order Designating Officers of the Division of Enforcement with the Authority to Issue Subpoena and Take Testimony (Aug. 13, 2013), *available at* http://www.cftc.gov/PressRoom/SpeechesTestimony/omailastatement081313.

415 The CFTC has the authority to bring actions before an administrative law judge as well, but has tended to choose to proceed in federal court.

416 CFTC Agency Financial Report: Fiscal Year 2012, at 23 (Nov. 2012), *available at* http://www.cftc.gov/ucm/groups/public/@aboutcftc/documents/file/2012afr.pdf.

contrast, the Commission's direct regulatory activities in registration, product reviews, and examinations are primarily focused on the DCMs, DCOs, SDRs, and SEFs. While the SROs are "obligated to conduct surveillance and enforcement activities under their purview, the Commission conducts surveillance and enforcement activities across all market participants."[417]

Self-regulation allows the SROs to conduct their own financial surveillance and compliance programs, which in turn permits the CFTC to rely on the SROs and play more of an oversight role. This arrangement is somewhat necessary given the CFTC's limited resources; self regulation allows the CFTC to instead focus on the financial integrity of the market and protection of customer funds more generally. SROs are expected to oversee member compliance with minimum financial and related reporting requirements, as well as certain non-financial requirements including disciplinary programs and the CFTC then performs review of such SRO examination programs.

One of the primary factors motivating self-regulation rather than direct government regulation is practicability; "it is more practicable for the exchanges to carry out regulation because of fast-changing market developments...[t]he scope of the regulations required would also result in an enormous government bureaucracy, and it is thought that direct government regulation would stifle the initiative of the industry." On the other hand, however, some have argued that allowing self-regulation is akin to "putting the fox in charge of the hen house."[418] Members may not want to create, apply or enforce rules that conflict with their own competitive and financial interests, creating a conflict of interest.

Allocation of responsibility. The allocation of primary responsibility between the CFTC, other regulators, and the SROs of the oversight of registered entities is complex and varies based upon the type of entity as well as the type of oversight conducted. The CFTC President's Budget and Performance Plan provides a Matrix of U.S. Registered Entities and Registrants by CFTC Mission Activity that proves helpful to illustrate the allocation of primary jurisdiction:

Entity	**CFTC Mission-Activity**					
	Registration & Registration Compliance	Product Reviews	Surveillance	Examinations	Enforcement	Economic & Legal Analysis
Trading Entities						
Designated Contract Market	CFTC	CFTC	CFTC	CFTC	CFTC	CFTC
Swap Execution Facility	CFTC	CFTC	CFTC	CFTC	CFTC	CFTC
Foreign Board of Trade	CFTC	CFTC	N/A	N/A	CFTC	CFTC
Clearing Entries						

417 CFTC President's Budget and Performance Plan FY 2015.

418 Markham, Jerry W, Commodities Regulation: Fraud, Manipulation & Other Claims, § 16.2 (2013) (quoting W. Douglas, Democracy and Finance 82 (Allen Ed. 1940)).

Entity	CFTC Mission-Activity					
	Registration & Registration Compliance	Product Reviews	Surveillance	Examinations	Enforcement	Economic & Legal Analysis
Derivatives Clearing Organization	CFTC	CFTC	CFTC	CFTC	CFTC	CFTC
Systemically Important Derivatives Clearing Organization	CFTC	CFTC	CFTC	CFTC/Federal Reserve	CFTC	CFTC
Data Repositories						
Swap Data Repository	CFTC	N/A	N/A	CFTC	CFTC	CFTC
Registered Futures Association						
National Futures Association	CFTC	N/A	N/A	CFTC	CFTC	CFTC
Intermediaries						
Futures Commission Merchant	NFA	N/A	DSRO/CFTC	DSRO/CFTC	DSRO/CFTC	CFTC
Swap Dealer	NFA	CFTC	NFA/CFTC	NFA/CFTC	NFA/CFTC	CFTC
Major Swap Participant	NFA	CFTC	NFA/CFTC	NFA/CFTC	NFA/CFTC	CFTC
Retail Foreign Exchange Dealer	NFA	N/A	NFA/CFTC	NFA/CFTC	NFA/CFTC	CFTC
Managed Funds						
Commodity Trading Advisor	NFA	N/A	NFA/CFTC	NFA	NFA/CFTC	CFTC
Commodity Pool Operator	NFA	N/A	NFA/CFTC	NFA	NFA/CFTC	CFTC
Other Registrants						
Introducing Broker	NFA	N/A	NFA/CFTC	NFA	NFA/CFTC	CFTC
Floor Broker	NFA	N/A	CFTC	N/A	SRO/CFTC	CFTC
Floor Trader	NFA	N/A	CFTC	N/A	SRO/CFTC	CFTC
Associated Person (Sales)	NFA	N/A	CFTC	N/A	SRO/CFTC	CFTC

One critique of this system of oversight is that it results in situations where no entity clearly has primary responsibility for the oversight of particular entities. In recent years, fraudulent enterprises (now the subject of bankruptcy proceedings) serve as a cautionary tale of the overlapping oversight of the CFTC, the SEC, exchanges and the NFA: numerous entities were charged to serve as watch dogs but no one uncovered the fraudulent activity until very late.[419]

CFTC Oversight of SROs. DSIO oversees the registration and compliance activities of SROs. DSIO "develop[s] regulations concerning registration, fitness, financial adequacy, sales practices, protection of customer funds, cross-border transactions, and anti-money laundering

[419] *See e.g. In re Peregrine Fin. Group, Inc*., No. 12-27488 (Bankr. N.D. Ill. 2012); *In re MF Global Holdings Ltd. et al.*, No. 11-15059 (Bankr. S.D.N.Y. 2012); *In re Sentinel Management Group, Inc*., No. 07-14987 (Bankr. N.D. Ill. 2007); *In re Refco, LLC*, No. 05-60134 (Bankr. S.D.N.Y. 2005)

programs, as well as policies for coordination with foreign market authorities and emergency procedures to address market-related events that impact intermediaries." In addition, with the passage of Dodd Frank, DSIO also is now "responsible for the development of, or monitoring for compliance with, regulations addressing registration requirements, business conduct standards, capital adequacy, and margin requirements for [swap dealers] and [major swap participants]."[420]

The CFTC has recently attempted to enhance its oversight of SROs by initiating a program to "increase the frequency of its assessments of financial surveillance programs" with the goal being "to conduct an annual assessment of certain core regulatory functions carried out by SROs" to "allow the Commission to have current information on the effectiveness of the surveillance programs and to identify and address potential issues on a more timely basis." [421]

There is often overlapping regulation of entities under the umbrella of CFTC regulation. The allocation of responsibilities is detailed below.

3. NFA

The CEA authorized the creation of "registered futures associations,"[422] and provides that such "registered futures associations" are responsible for a number of oversight functions, including registration, background checks, administration of competency examinations for individuals, training, audit, enforcement and supervision of all members.[423] In addition, "registered futures associations" are required to establish minimum capital, segregation and other financial requirements applicable to their members, minimum standards governing the sales practices of its members; and "establish special supervisory guidelines to protect the public interest relating to the solicitation by telephone." These standards must be consistent with the requirements of the CEA.

Pursuant to this section, the NFA was established in 1982 and constitutes a nationwide, industry-sponsored SRO. It is the CFTCs so-called "first-line regulator."

The NFA's responsibilities include to "thoroughly screen[ ] all firms and individuals wishing to register with the CFTC and become Members of the NFA," including stringent fitness requirements, background checks and comprehensive proficiency testing requirements. The NFA performs regular examinations of its Members to ensure compliance and conducts financial surveillance to enforce compliance, and "provides a variety of regulatory services and programs

[420] CFTC Annual Report FY 2015.
[421] CFTC Strategic Plan FY 2011-2015.
[422] 7 U.S.C. § 21
[423] *Id*.

to electronic trading platforms to ensure the fair treatment of customers and to maintain orderly markets."[424]

Looking forward, the CFTC is working with the NFA on the development of a "comprehensive program for the oversight and assessment of SD and MSP compliance;" a program that will be administered by the NFA.[425] As such, the NFA will also serve as the frontline regulator for these entities as well, a substantial expansion of the NFA's responsibilities.

4. CME as SRO

The Chicago Mercantile Exchange Group (CME Group), a publicly traded for profit entity, also has significant SRO functions particularly for clearing members. Certain CME Group entities, CME, the Chicago Board of Trade (CBOT), and the New York Mercantile Exchange (NYMEX), all serve also as SROs for registered entities that are also clearing members of DCOs. In the wake of MF Global, a number of individuals have criticized this arrangement, noting that when the New York Stock Exchange became a publicly traded for profit entity, it was required to spin out its SRO functions into what is now FINRA.[426]

5. DCMs and SEFs as Regulators of Their Own Markets

Status as a DCM imposes a duty to self regulate. DCMs "shall establish, monitor, and enforce compliance with the contract market, including (i) access requirements; (ii) the terms and conditions of any contracts to be traded on the contract market; and (iii) rules prohibiting abusive trade practices on the contract market." [427] DCMs generally have broad discretion, subject to the Commission, to admit members; develop and enforce rules designed to insure fair dealing; discipline offenders; expel members; determine certain contract terms and price fluctuation limits; and establish margin requirements.[428]

These requirements are "designed to maintain futures markets as a centralized marketplace in which prices are determined openly and competitively and to facilitate regulation of the futures markets through Commission oversight of the futures exchanges."[429]

---

[424] www.nfa.futures.org

[425] CFTC Strategic Plan FY 2011-2015.

[426] See, e.g., U.S. Congressional Research Service. The MF Global Bankruptcy, Missing Customer Funds, and Proposals for Reform (R42091 August 1, 2013), at p. 5

[427] 11 U.S.C. § 7(d).

[428] *Id*.

[429] Collier on Bankruptcy ¶ 760.05 (16th ed.).

SEFs have analogous responsibilities. While the Dodd-Frank Act imposes different statutory provisions on SEFs than on designated contract markets, the CEA similarly requires that SEFs establish and enforce trading, trade processing and participation rules that will deter abuses and have the capacity to detect, investigate, and enforce those rules.[430] In addition, SEFs are required to "monitor trading in swaps to prevent manipulation, price distortion and disruptions of the delivery or cash settlement process through surveillance, compliance and disciplinary practices and procedures."[431]

The CFTC reviews major DCMs and SEFs and their exercise of regulatory authority. Of the major DCMs reviewed by the CFTC, CME Group is the largest and includes four major DCMs (CME, CBOT, NYMEX and COMEX). For non-major DCMs and SEF's, including the Minneapolis Grain Exchange, NADEX and One Chicago, the CFTC faces insufficient resources for a robust review. Thus, the CFTC has modified its RER (rule enforcement review) "to focus on a specific area of a DCM's self-regulatory responsibilities, *e.g.* trade practice surveillance or audit trail, rather than reviewing all or most of a DCM's self regulatory programs."[432]

G. Congressional Oversight and Appropriations

The Senate Committee on Agriculture, Nutrition and Forestry (SCA) and the House Committee on Agricultural (HCA) have oversight jurisdiction of the CFTC. This oversight structure stems from the CFTC's traditional role as the regulator of futures and options contracts on agricultural commodities. Since the 1970s, however, trading in derivatives has expanded significantly beyond traditional physical and agricultural commodities into a vast array of complex financial instruments. While agricultural end-users continue to utilize the futures markets to lock-in prices for crops and livestock, highly complex financial contracts based on interest rates, foreign currencies, Treasury bonds, securities indexes, and other products now far exceed agricultural contracts in trading volume.[433] Jurisdiction, however, remains with the agriculture committees.

Nevertheless, as a result of the dramatic increase in financial derivatives trading, the Senate Committee on Banking, Housing, and Urban Affairs (SCB) and the House Committee on Financial Services (HFS) have taken increasingly active roles in monitoring the CFTC. For example, former CFTC Chairman Gary Gensler testified before the SCB at least 12 times during

---

[430] 7 U.S.C. § 7b-3.

[431] *Id.*

[432] CFTC Annual Report FY 2012.

[433] The CFTC estimated that in 2010, only about 8% of on-exchange commodity futures and options trading activity occurred in the agricultural section, whereas financial commodity futures and option contracts made up approximately 79% of all trading activity on the futures exchanges. *See* CFTC STRATEGIC PLAN FY 2011-2015, at 5 (2011). Other contracts, such as those on metals and energy products, made up the remaining 13%. *See id.* Additionally, with the passage of the Dodd-Frank Act in July 2010, the CFTC is now tasked with regulating the U.S. swaps market, which it estimates has a gross notional value of approximately $400 trillion. *See* CFTC PRESIDENT'S BUDGET & PERFORMANCE PLAN FY 2015, at 1 (2014).

his tenure,[434] addressing topics such as (1) implementing Title VII of the Dodd-Frank Act, (2) examining the causes of the May 6, 2013 Flash Crash, (3) improving oversight of the OTC derivatives markets, (4) mitigating systemic risk in the derivatives markets, (5) examining the efficiency, stability, and integrity of the U.S. capital markets, and (6) reviewing investigations and regulatory actions in the mutual fund industry.[435] By contrast, the immediately preceding chairman, former CFTC Chairman Reuben Jeffery III, testified before the SCB only once during his tenure.[436] [437]

The SCA and HCA have also shifted their oversight focus to place more emphasis on financial derivatives trading and its impact on agricultural end-users. As recently as May 2014, the SCA held a hearing on the impact of automated and high-frequency trading on the futures markets.[438] In her opening remarks, SCA Chairperson Debbie Stabenow emphasized the importance of understanding whether the advent of automated and high-frequency trading created additional risks for farmers, ranchers and other agricultural end-users.[439] Vince McGonagle, the Director of the DMO, testified before the SCA to provide an overview of the CFTC's Concept Release on Risk Controls and System Safeguards for Automated Trading Environment, which he described as a proactive effort to evaluate technology driven changes in the U.S. derivatives markets—including automated and high-frequency trading—to ensure the safety and soundness of those markets.[440] [441]

1. Appropriations and Funding

The CFTC relies on Congress for appropriations to fund its operations, and submits annual operating budgets and performance plans to the Committees on Appropriations in the U.S. Senate and House of Representatives. In addition, Congress must act to reauthorize the CFTC through legislation every 5 years, though the CFTC can continue to operate while reauthorization is pending.

---

434 Gary Gensler served as Chairman of the CFTC from 05/26/2009 to 01/03/2014. *See* http://www.cftc.gov/About/Commissioners/FormerCommissioners/index.htm.

435 *See* Hearings Witness List, U.S. Senate Committee on Banking, Housing & Urban Affairs, *available at* http://www.banking.senate.gov/public/index.cfm?FuseAction=Hearings.WitnessList.

436 Reuben Jeffrey III served as Chairman of the CFTC from 07/11/2005 to 06/27/2007. *See* http://www.cftc.gov/About/Commissioners/FormerCommissioners/index.htm.

437 *See* CFTC Speeches & Testimony, Commissioner Reuben Jeffery III, *available at* http://www.cftc.gov/About/Commissioners/jefferyspeeches.

438 *See High Frequency & Automated Trading in Futures Markets: Hearing before U.S. Senate Committee on Agriculture, Nutrition & Forestry*, 113th Cong. (2014).

439 *See id.*

440 *See id.*

441 http://www.cftc.gov/PressRoom/SpeechesTestimony/opamcgonagle05131.

2. The CFTC's 2015 Budget Request.

The CFTC's annual operating budget was approximately $200 million in FY 2013, was approximately $216 million in FY 2014, is estimated to be approximately $250 million in FY 2015, and the President has requested a budget of $322 million for FY 2016.[442] Of the $322 million requested for the CFTC for FY 2016, the agency estimated it would spend approximately $70 million (22%) on enforcement; $62 million (19%) on surveillance; $35 million (11%) on examinations; $63 million (20%) on data and technology; and would divide the remaining funds amongst its various other activities.[443]

The CFTC's approximately 10% budget increase from $200 million in FY 2013, to $215 million in FY 2014, was $100 million below what President Obama requested for the agency and has raised concerns that the CFTC is insufficiently funded, especially given the agency's significantly expanded regulatory role under the Dodd-Frank Act.

The CFTC has expressed concerns about its budget on several occasions. In 2011, the CFTC stated in its Strategic Plan:

> The CFTC's current funding is far less than what is required to properly fulfill its significantly expanded role [under the Dodd-Frank Act]. The CFTC has requested additional funds, and without the requested resources the Commission may not be able to meet its strategic goals, nor its statutory and regulatory obligations.[444]

In 2014, the CFTC stated in its Strategic Plan:

> Current resource constraints may limit the agency's ability to achieve all its goals, or the speed with which certain goals can be achieved. We are committed to doing all we can, and will continue to use the resources we have available in the most efficient and productive way possible. Without additional resources, however, our markets cannot be as well supervised; participants cannot be as well protected; market transparency and efficiency cannot be as fully achieved.[445]

The CFTC is the only financial regulatory agency that is not at least partially self-funded. While other government agencies impose fees on the businesses they regulate and collect fines from regulatory enforcement to fund operations, the CFTC has never had the authority to do so. For example, although the SEC relies in part on Congressional appropriations for funding, it is

---

[442] *See* CFTC President's Budget & Performance Plan FY 2016, at 9 (2015).

[443] *See id*. at 8.

[444] Strategic Plan FY 2011-2015, at 6.

[445] Strategic Plan FY 2016-2018, at 3.

authorized to keep the fines it exacts through enforcement actions to help fund its operations, though it may not spend funds above its appropriations.

a. Agency Reauthorization

In addition to appropriating funds for the CFTC, Congress must act to reauthorize the CFTC through legislation every 5 years. Congress typically uses the reauthorization process as an opportunity to amend the CEA and update the CFTC's authorities and recommended spending levels.

As the Committees responsible for CFTC oversight, the SCA and HCA are responsible for initiating reauthorization legislation. Reauthorization legislation approved by the SCA or HCA must be approved by the full Senate or House of Representatives (depending on the chamber in which the legislation originated), and then by the full Congress before being presented to the President. The CFTC also typically comments on the legislation prior to it becoming law.

The most recent CFTC Reauthorization Act was approved in 2008, as part of the Food, Conservation and Energy Act (PL 110-246). That reauthorization expired on September 30, 2013, and the CFTC has been relying on unauthorized appropriations since that time.[446]

Beginning in approximately 2013, as part of the reauthorization process, the SCA and HCA began holding a number of hearings on a range of issues, including how to increase consumer protection and the failure of MF Global and Peregrine.[447] As part of these hearings, the Committees invited "witnesses to share testimony on how to strengthen our current laws to ensure that markets are operating as intended" so that market users "are protected from fraud, manipulation and abusive practices."[448] The Committees also received letters from several stakeholders—including the CME Group, Futures Industry Association, National Futures Association, and the Farm Credit Council—which discussed challenges in the industry and made suggestions for how to improve current laws and regulations.[449]

---

[446] Congress controls federal spending two ways: (1) through appropriations legislation which allows a federal agency to withdraw money from the U.S. Treasury, and (2) through authorization legislation that authorizes the expenditure of money by federal agencies. Congressional power over appropriations stems from Article 1, Section 9 of the U.S. Constitution, which states that "[n]o money shall be drawn from the Treasury, but in consequence of appropriations made by law." The authorization process, however, stems from the internal rules of the Senate and House of Representatives, and thus is a more flexible requirement. Although the U.S. Constitution prohibits the spending of any money without appropriation, it is possible to appropriate money without it first being authorized. This is commonly referred to as an unauthorized appropriation.

[447] *See, e.g.*, Reauthorization of the CFTC: Hearing before U.S. Senate Committee on Agriculture, Nutrition and Forestry, 113th Cong. (2013); The Future of the CFTC: Perspectives on Customer Protections: Hearing before U.S. House Committee on Agriculture, 113 Cong. (2013).

[448] *See, e.g.*, Reauthorization of the CFTC: Hearing before U.S. Senate Committee on Agriculture, Nutrition and Forestry, 113th Cong. (2013).

[449] *See id.*

On June 24, 2014, the House of Representatives passed H.R. 4413, entitled the "Customer Protection and End-User Relief Act" (the "Reauthorization Act"). The Reauthorization Act reauthorizes the operations of the CFTC through 2018. In addition to reauthorizing the CFTC, the Reauthorization Act would, if enacted, amend the CEA to, among other things:

- require statutorily the CFTC and SEC to issue joint rules regarding the application of U.S. swaps rules to transactions made between U.S. and foreign entities;
- require the CFTC to consider additional factors when conducting its cost-benefit analyses for rules promulgated under the CEA;
- require the CFTC to conduct a study on high-frequency trading no later than one year after the enactment of the Reauthorization Act;
- amend the procedures for taking actions without a full vote of the CFTC commissioners;
- provide relief to end-users from certain requirements implemented under the Dodd-Frank Act, including margin, reporting, and recordkeeping requirements; and
- enhance certain protections, including bankruptcy protections, afforded to customers of FCMs.

The Senate considered its own reauthorization legislation and did not pass the Reauthorization Act in the form passed by the House. The White House has indicated that it opposes the House bill.[450] The issue remains unresolved.

b. CFTC and the FSOC

The Chair of the CFTC serves as the CFTC's voting member of the Financial Stability Oversight Council (FSOC).[451] However, much of the CFTC's daily engagement with the FSOC is done by CFTC staff, acting as the Chair's deputies. The FSOC's Deputies Committee meets every two weeks and the CFTC is represented by these personnel, which include his or her front office staff, the General Counsel and various Division heads or assistant Division heads. These individuals attend other staff level meetings organized by the FSOC devoted to policy issues and engage on Council-related matters, with the approval of the Chair, on behalf of the CFTC. These matters includes designations, the annual report, and other issues as noted below.

---

[450] On June 19, 2014, the Executive Office of the President issued a statement on the Reauthorization Act, stating that it "strongly opposes the passage of H.R. 4413 because it undermines the efficient functioning of the [CFTC] by imposing a number of organizational and procedural changes and offers no solution to address the persistent inadequacy of the agency's funding." Executive Office of the President, *Statement of Administration Policy H.R. 4413 – Customer Protection and End User Relief Act* (2014).

[451] The FSOC bylaws authorize the Chair to delegate his responsibilities to another officer or employee of the CFTC. Rules of Organization of The Financial Stability Oversight Council § XXX.2(e)(2)

As noted elsewhere in this memo,[452] the CFTC's staffing and budgeting restrictions have restricted its ability to pursue its mandate, including with respect to its FSOC responsibilities. Throughout the FSOC's existence, the CFTC only has been able to dedicate limited staff to FSOC-related matters. At times this has affected the agency's ability to engage as fully as it would have liked on certain issues. For example, because of staffing the CFTC may occasionally be unable to submit and review comments to the various issues set for discussion by the FSOC in as robust a manner as it would like.

c. Specific FSOC Activities

While the CFTC has been engaged in all FSOC activities, in recent years, the designation of systemically important financial institutions (SIFIs) and designating systemically important financial market utilities (SIFMUs) have taken priority.

d. Designations

Under sections 113 and 804 of the Dodd-Frank Act, the FSOC may designate non-bank financial companies as SIFIs and SIFMUs for enhanced supervision by the Federal Reserve and in conjunction with other federal regulators.

From the CFTC's perspective, the designations of SIFMUs have more significant implications for its core mandate. Under Dodd-Frank, the FSOC "shall designate those financial market utilities or payment, clearing, or settlement activities that the FSOC determines are, or are likely to become, systemically important."[453] Pursuant to this authority, on July 18, 2002, the FSOC designated eight financial market utilities as systemically important.[454] The designated utilities are: the Clearing House Payments Company, LLC, CLS Bank International, the Chicago Mercantile Exchange, Inc. (CME), the Depository Trust Company, Fixed Income Clearing Corporation, Ice Clear Credit LLC (Ice Clear Credit), National Securities Clearing Corporation, and the Options Clearing Corporation (OCC).[455] Three of these SIFMUs are CFTC-registered DCOs (CME, Ice Clear Credit, and OCC), however, the CFTC is the supervisory agency only for CME and Ice Clear Credit.[456]

The CFTC is the primary regulator of a number of the largest SIFMUs. Section 805(a) of the Dodd-Frank Act authorizes the CFTC to prescribe regulations for those DCOs that the FSOC has determined are systemically important.[457] Section 807(a) further provides that the CFTC

---

452 *See* this memo pgs. 81-82.
453 12 U.S.C. § 5463.
454 Financial Stability Oversight Counsel, Annual Report, App. A (2012).
455 *Id*.
456 Derivatives Clearing Organizations & International Standards, 78 Fed. Reg. 72476, 72477 n.13 (Dec. 2, 2013).
457 12 U.S.C. § 5464(a)(2).

must conduct examinations of SIFMUs at least once a year to determine, among other things, "the nature of the operations of, and the risks borne by, the designated financial market utility."[458]

As part of the FSOC's designation of these SIFMUs, the CFTC adopted final rules to establish additional standards for compliance with the DCO core principles set forth in the CEA for systemically important DCOs.[459] Pursuant to those new rules, each SIFMU must maintain viable plans for (1) recovery or orderly wind down, necessitated by uncovered credit losses or liquidity shortfalls; and separately, (2) recovery or orderly wind-down necessitated by general business risk, operational risk, or any other risk that threatens the SIFMU's viability.[460] The rules also, however, give the Federal Reserve back-up examination and rulemaking authority.

The FSOC also has authority to designate non-bank financial companies as SIFIs and one of the significant issues the FSOC faced recently was whether asset managers should be so designated. Many asset managers are dually registered with the SEC as investment companies and with the CFTC as CPOs, but are exempt from many burdens associated with that CFTC registration. Asset management companies contend that designation of an asset manager as a SIFI may have substantial effects on how it is regulated and that banking regulations, applicable to SIFIs, are not designed for their industry.[461] The FSOC determined that it would focus first and specific activities of asset managers rather than designating asset managers as SIFIs for the time being.

e. Other Council Matters

The FSOC has also served as a venue for discussion concerning regulatory topics with inter-agency components. These non-FSOC authority issues may involve matters that do not directly implicate the FSOC statutory authorities, but include, among others, matters that require cross-agency coordination. Examples of these matters include the CFTC and SEC's coordination concerning derivatives regulation, and in particular the harmonization of cross-border derivatives rules; coordination among the five agencies drafting of the Volcker Rule[462]; and the FSOC's response to concerns regarding the setting of interest rate benchmarks, such as LIBOR and Euribor in which the CFTC played a significant role. These matters, and others like them, arise on a fairly regular basis and the CFTC engages with other regulators through the FSOC framework.

---

458 12 U.S.C. § 5466(a).

459 Derivatives Clearing Organizations & International Standards, 78 Fed. Reg. 72476, 72446 (Dec. 2, 2013).

460 *Id*.

461 *See* The Impact of Dodd-Frank on Customers, Credit, and Job Creators: Hearing Before the S. Comm. on Capital Markets and Government Sponsored Enterprises, Comm. On Financial Services 112 Cong. (2012) (Statement of Thomas P. Lemke, Investment Company Institute).

462 The Volcker Rule was drafted among a smaller group of agencies and through a different system, though many of the same CFTC participants in the Council proceedings participated in and played a role in the CFTC's Volcker efforts.

III. THE SEC AND THE CFTC: PHILOSOPHIES, RULES, AND POLICIES

While both the SEC and the CFTC focus on market integrity, investor protection, and price discovery, they differ in some of their other priorities. For example, a primary focus of securities markets and securities market regulation, for both debt and equity, is facilitating capital formation. Derivatives markets (and regulation), in contrast, are primarily intended to facilitate and manage risk transfer. The former rely heavily on mandatory disclosure of non-public information to support investor decision making. Regulation of the latter, however, is not predicated on disclosure, at least in part because CFTC derivatives markets are in large measure based on mass scale commodities and financial metrics, the prices of which should not turn on the status of any individual market participant.[463] In the view of many observers, these factors and the "unique capital formation role of certain securities markets has informed the manner in which the two regulatory regimes have developed and, in part, explain[s] differences between the regulatory structure of the CFTC and the SEC."[464]

Capital formation, unlike risk transfer, often involves the demand for capital from opaque institutions. Information concerning both new and existing companies is not generally publicly available. In contrast, risk transfer generally concerns broader macroeconomic factors – such as interest rates, currency rates, or commodity prices – about which information is more broadly dispersed. As a result the two regulators take different approaches to reviewing and approving new product listings. The SEC views high quality disclosure as the cornerstone of investor confidence and capital formation, and necessary for capital markets to function effectively. As a result, the SEC has wide discretion in granting or denying approval to the listing of new instruments. New offerings are required to go through review by the Division of Corporation Finance before they can be offered publicly.[465] The CFTC, on the other hand, does not have *ex ante* approval authority for new exchange-listed products. While it can delay listing while it seeks public comment for 90 days, it only can premise any disapproval on an affirmative finding that the product violates the CEA.[466]

In addition, the regulation of central clearing plays a much larger role for the CFTC then it does for the SEC. Central clearing of derivatives mutualizes credit risk among clearing members and creates operational efficiencies by effectively netting bilateral exposures among clearinghouse participants. In contrast, securities clearing largely concerns settlement and delivery of instruments versus payment for those instruments. Once settlement occurs, there is usually no continuing credit exposure between the two trading parties in most SEC regulated products.

---

463 Where CFTC regulated markets could be affected by particularly sensitive inside information, for example governmental information, the CFTC does regulate trading on such information. *See, e.g.*, Section 746 of the Dodd-Frank Act.

464 A Joint Report of the SEC and the CFTC on Harmonization of Regulation [hereinafter Joint Report], Oct. 16, 2009, available at http://www.sec.gov/news/press/2009/cftcjointreport101609.pdf.

465 *Id.*

466 *Id.*

Central clearing, by its very nature, involves the concentration of a very large amount of credit risk in a single utility. While the utility should have little to no market risk, it does have very large exposures to all of its members, a risk that it mitigates with mandatory margin requirements, guarantee fee contributions, and capital. The regulation of central clearing is a core function of the CFTC that, while somewhat present for the SEC, is simply not as high a priority.

Other areas where the differences between the SEC and CFTC play out, as highlighted in a 2009 Joint Report on regulatory harmonization by the agencies, include risk-based portfolio margining and bankruptcy/insolvency regimes; linked national market and common clearing versus separate markets and exchange-directed clearing (vertical integration); price manipulation standards; customer protection standards applicable to financial advisers; regulatory compliance by dual registrants; and cross-border regulatory matters.[467]

A. CFTC/SEC Harmonization (Separately or in a Merged Agency)

The "Blueprint" for financial reform prepared by the Department of the Treasury in 2008 called for the merger of the CFTC and SEC and suggested that harmonization be achieved by (a) the SEC adopting an approval approach for SROs and new products modeled on the CFTC's principles-based approach (with, for example, self-certification of rules amendments by SROs); and (b) establishing a task force to hammer out other substantive differences.[468] The Joint Report on regulatory harmonization does not take a firm position on which approach is preferable, but notes that commentators "have stated that the agencies' oversight of exchange and clearinghouse rules should balance the opportunity to comment with the speed provided by self-certification."[469] While some commentators emphasized the advantage of speed under the CFTC approach, others noted "that a prior approval process, including one that involves a comment procedure, is important because it creates legal certainty and permits regulators to exercise oversight with proper information, which is derived in part from public input on significant issues during the comment process."[470] In any event, rule-approval harmonization would have to occur along two dimensions: (i) speed, which may already be *partially* addressed by the SEC's (new) expedited review requirements; and (ii) agency discretion.

It is important to note that significant harmonization has, in fact, occurred since the 2009 Joint Report. While the CEA follows a principles-based approach in reviewing rule changes for SROs, including clearinghouses and exchanges, revisions in the Dodd-Frank Act have made the CEA somewhat more prescriptive. For example, the Dodd-Frank Act significantly limited the ability of registered entities (DCMs, DCOs, and SEFs) to self-certify rule changes and product

---

467 *Id.*

468 The Department of the Treasury Blueprint for a Modernized Financial Regulatory Structure [hereinafter Blueprint] 12-13, March 2008, http://www.treasury.gov/press-center/press-releases/documents/Blueprint.pdf.

469 Joint Report, supra note 464.

470 *Id.*

listings. While the principles-based approach grants SROs "significant discretion in the manner in which [they] satisf[y] the statutory core principles," the CFTC now, as a practical matter, has ex ante authority to review rule changes with its authority to stay self-certifications and seek public comment. This better aligns CFTC authority with the SEC, which must approve many of the rules changes of the SROs under its jurisdiction *before* those changes become effective,[471] and publishes these proposed rule changes for public comment.[472]

B. Costs and Benefits of an SEC/CFTC Merger

Proponents of a merger point to the degree to which the line separating the products regulated by the CFTC and SEC, once quite distinct, has blurred: "financial engineers [have] developed products that ha[ve] the attributes of both futures and securities, thus helping to confuse the line between futures and securities regulation."[473] Proponents also point to the overlap in entities regulated by the agencies; for example, approximately 45 percent of futures commission merchants (FCMs) registered with the CFTC are *also* registered as broker dealers with the SEC.[474] Many investment entities are also dually registered IAs and CPOs. Finally, they point to the degree to which securities and derivatives markets are linked, with trading strategies of market participants often encompassing many or even all of the types of markets regulated by the SEC and CFTC, but without any "general surveillance and enforcement of this intermarket trading, leading to gaps in investor protection and unnecessary market volatility."[475] Thus, those who support a merger of the CFTC and SEC usually see the benefits as regulatory streamlining, improved regulation and surveillance of linked markets, and the elimination of redundancies. The 2008 Treasury Blueprint posits that the "realities of the current marketplace have significantly diminished, if not entirely eliminated, the original reason for the regulatory bifurcation between the futures and securities markets."[476] Indeed, "[p]roduct and market convergence, market linkages, and globalization have rendered regulatory bifurcation of the futures and securities markets untenable, potentially harmful, and inefficient."[477]

With respect to costs, in addition to the potentially large (if one-time) transition costs of merging two large agencies, many fear the loss of the CFTC's principles-based approach. The 2008 Treasury Blueprint – which, as noted, recommends that the SEC move toward the CFTC's principles-based approach – observes that "[m]arket participants have … noted the benefits of

---

471 Roughly one-third of proposed rule changes must be approved by the SEC before becoming effective, *id.*, though Dodd-Frank mandated that such rules be reviewed and approved or disapproved on a "significantly expedited basis," CBJ 2015, supra note 1, at 66.

472 Joint Report, supra note 463.

473 Joint Report, supra note 463, at 16. The report cites "index participations" as an example: "these contracts are based on the value of an index of securities, usually cash-settled, and they are designed to trade as securities on securities exchanges." The SEC and CFTC fought over jurisdiction of these instruments, with the 7th Circuit ruling in favor of the CFTC in 1989. *Id.*

474 *Id.*

475 Blueprint, supra note 468, at 109.

476 Blueprint, supra note 468, at 11.

477 *Id.*

such an approach: flexibility to adapt to market changes, outcome-focused [sic], acknowledgement of the possibility of more than one path to regulatory compliance, allowing for creativity and innovation, and facilitation of global regulatory cooperation."[478] Finally, some fear that compromises as the merger is implemented could wind up *adding* to regulatory burden on regulated entities.[479]

C. The "Three Peaks" Model

It would likely be feasible to implement the entire scope of the SEC's regulatory functions in the context of a "three peaks" model, with a macro market stability regulator, a microprudential regulator, and a market conduct regulator. The functions of the SEC's three core functional divisions – Corporation Finance (focused on corporate disclosures), Trading and Markets (focused on broker-dealers, exchanges, clearing agencies, and other SROs), and Investment Management – would be subsumed into the market conduct regulator, along with its examination and enforcement functions and other specialized units (such as the Office of Credit Ratings). (It is worth noting that the 2008 Treasury Blueprint recommended a three-peaks approach *but* also recommended a separate "Corporate Finance Regulator," in addition to the "Business Conduct Regulator." The proposed Corporate Finance Regulator would have taken on the "SEC's current responsibilities over corporate disclosures, corporate governance, accounting oversight, and similar issues."[480] It would be feasible, however, to incorporate these functions – now, largely the domain of the SEC's Division of Corporation Finance – into the scope of the Market Conduct Regulators' oversight.)

An advantage of this approach is that it could prove to be an efficient way to address some of the regulatory challenges highlighted in this memo – for example, a macroprudential regulator could focus more on the potential risks of shadow-banking among (for example) broker-dealers and money-market funds, and address these risks more proactively. It is important to note, of course, that the SEC has the power currently to address these risks; speculation on the advantages of the objectives-based (i.e., three-peaks) approach relies on assumptions about the likely regulatory attitude – driven by the institutional mandates – of the different objectives-based regulators.

Note however that this three peaks model does not specifically address which entity would have primary responsibility for promoting capital markets efficiency. Currently both the SEC and the CFTC have responsibility for promoting price discovery within the entities they monitor. This function is distinct from markets conduct regulation as it is less focused on things like insider trading and price manipulation and more on market design and structure. This

---

478 *Id.*

479 *Dodd-Frank's Missed Opportunity: A Road Map for a More Effective Regulatory Architecture* at 12-13, Bipartisan Policy Center, April 2014, available at http://bipartisanpolicy.org/library/report/dodd-frank%E2%80%99s-missed-opportunity-road-map-more-effective-regulatory-architecture.

480 Blueprint, supra note 467, at 21.

function is critical to a well-functioning financial system as efficient markets can help systems absorb liquidity or solvency events in times of stress.