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Investment Management
Client Alert Series

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Treasury Blueprint for Regulatory Reform – Securities and Commodities Regulation

Introduction

In our *Client Alert* dated April 1, 2008, we provided highlights of the Department of the Treasury Blueprint for a Modernized Financial Regulatory Structure (“Blueprint”). The Blueprint sets forth recommended actions for overhauling the U.S. financial regulatory structure. Among the recommendations proposed by the Blueprint is the merger of the Commodity Futures Trading Commission (“CFTC”) and the Securities and Exchange Commission (“SEC”). Such a consolidation would bring oversight of the U.S. commodities and securities markets under a single regulatory regime.

The current framework for commodities and securities regulation is bifurcated with the CFTC having primary jurisdiction over the commodities markets and the SEC having primary responsibility for enforcing the federal securities laws and regulating the national securities markets. Worthy of note is that the CFTC regulates commodities traded on an exchange, but does not directly regulate the over-the-counter market, *i.e.* transactions typically reflected on an ISDA Master Agreement. The SEC, on the other hand, regulates securities both on exchanges and off exchanges. The bifurcated framework was largely established over seventy years ago when the commodities and securities markets were distinctly separate. Since then, financial innovation has increasingly blurred the lines between commodities and securities, some say making the distinctions in oversight less clear and diminishing the original reason for a separate regulatory regime. To address this issue, the Blueprint calls for combined oversight over the commodities and securities markets by merging the CFTC and SEC.

Rather than integrating the CFTC and SEC in a single action, the Blueprint suggests a series of steps in order to preserve the best features of each agency. The Blueprint is particularly mindful of retaining the CFTC’s flexible, principles-based regulatory philosophy. In general, a principles-based approach requires regulated entities to meet certain core principles in conducting their business operations. In contrast, the SEC is dominated by a rules-based approach, which sets forth regulations that institutions must follow. A criticism of a rules-based approach is that it may be exploited to circumvent the intention of the rules and elude the SEC’s oversight. Another result is that the SEC’s review process can delay the introduction of products for lengthy periods, sometimes for years. Unlike the SEC’s rules-based approach which focuses on ensuring that every action protects individual investors, a principles-based approach focuses more on overall market integrity. Thus, according to some interested parties, the CFTC is able to act swiftly on new products and introduce products at a quicker pace than the SEC might permit. According to CFTC Commissioner Bart Chilton, the advantages of a principles-based approach is supported by the num-

bers. He points out that “[s]ince [the CFTC] began using the more flexible principles-based regulatory regime, the worldwide derivatives sector has increased two-fold. But in the U.S., it has more than tripled.”

Additionally, the CFTC regulatory approach also relies heavily on self-regulation. So while the CFTC provides government oversight for the entire exchange-traded commodities industry, the commodities industry is largely regulated by the National Futures Association, an independent self-regulatory organization (“SRO”). The SEC, on the other hand, despite having SROs such as the Financial Industry Regulatory Authority (“FINRA”), continues to play a more direct role than the CFTC.

Evolutionary Steps Leading Up to the Merger between CFTC and SEC

Acknowledging the market benefits achieved by the CFTC’s principles-based regulatory philosophy, the Blueprint recommends that the SEC undertake the following pre-merger steps to move the SEC toward a principles-based approach:

- **Core Principles.** Modeled after the core principles adopted for derivative clearing agencies and futures exchanges, the SEC should adopt similar core principles for securities clearing agencies and exchanges.
- **SRO Rule Changes.** The SEC should expedite the procedures for approving SRO rules and products. Streamlining the approval process should include such considerations as the adoption of a firm time limit for the SEC to publish SRO rule filings and more clearly defining and expanding the type of rules deemed effective upon filing.
- **Investment Company Act Exemptions and Expansion.** The SEC should adopt a general exemption under the Investment Company Act of 1940 to allow the trading of products substantially similar to those products already actively trading pursuant to exemptive orders in the U.S. or foreign jurisdictions. The effect of such a rule is to permit the introduction of new funds that meet the same terms and conditions of already exempt funds without a lengthy review process by the SEC. The Blueprint also recommends that the SEC propose congressional legislation that would expand the Investment Company Act of 1940 by permitting registration of a new “global” investment company. The global investment company regulation would be designed to provide investor protections equivalent to the current U.S. investment company regulatory structure.

Consummation of the Merger between CFTC and SEC

By moving the SEC toward a principles-based approach, the pre-merger steps are designed to render the SEC regulatory regime more conducive to the modern marketplace and help to facilitate a smooth merger between the CFTC and SEC. The Blueprint

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also recommends that the merger plan should address the following considerations:

- **Overarching Principles.** Concurrent with the merger, the combined agency should adopt overarching regulatory principles by incorporating the best regulatory philosophies from each of the CFTC and SEC. The overarching principles should focus on investor protection, market integrity and overall financial system risk reduction.

- **Self-Certification of SRO Rule Changes.** All clearing agency and market SROs should be permitted by statute to self-certify all rulemakings (except those involving corporate listing and market conduct standards), which would then become effective upon filing. The CFTC and SEC should retain the authority to defeat any rulemaking.

- **Harmonization of Commodities and Securities Statutes and Regulations.** A joint CFTC-SEC staff task force with equal agency representation should be established with the authority to harmonize the complex differences in commodities and securities regulation. The task force should also be assigned the responsibility of recommending the structure of the merged agency.

Other Recommendations Affecting the Commodities and Securities Industries

Although the merger of the CFTC and SEC is the Blueprint's principal proposal to modernize the commodities and securities industries, it also recommends that investment advisers be subject to a self-regulatory regime similar to that of broker-dealers. Current federal securities laws require registered broker-dealers to be members of an industry SRO (typically FINRA), whereas registered investment advisers have no similar requirement. The Blueprint also calls for harmonizing oversight over both investment advisers and broker-dealers, potentially placing oversight of both professions under the same SRO. According to the Blueprint, these changes are appropriate given the convergence of the services provided by investment advisers and broker-dealers. Further impetus for the recommendations is the belief that self-regulation of investment advisers would improve investor protection and lead to more cost-efficient regulation.

The Blueprint also provides a longer-term view envisioning the creation of new agencies, including the Conduct of Business Regulatory Agency. The Conduct of Business Regulatory Agency as part of an "optimal" regulatory structure would assume many of the roles of the CFTC and SEC, including the SEC's current regulatory and enforcement duties over financial institutions. The agency would be charged with consumer protection across all types of financial firms and handle such issues as rule writing for disclosures, business practices, and chartering and licensing financial firms. The Blueprint also recommends the creation of a Corporate Finance Regulator, which would take over other SEC responsibilities including corporate disclosures, corporate governance, and accounting. Under the Blueprint's scenario, the SEC would effectively be eliminated

and its responsibilities primarily divided up between the Conduct of Business Regulatory Agency and the Corporate Finance Regulator.

Looking Forward

While there is widespread consensus that modernization of the current U.S. regulatory structure is necessary to ensure that the U.S. maintains its competitiveness in the global capital markets, the Blueprint's plan to overhaul the U.S. commodities and securities markets has drawn mixed reaction. For instance, critics of the merger, including consumer and investor groups, oppose the implementation of a CFTC-like model by the SEC. They argue that such a move would drive standards down by diluting the SEC regulatory and enforcement culture. Furthermore, the Investment Adviser Association ("IAA") strongly disagrees that the imposition of an investment adviser SRO would lead to cost efficiencies. Rather, the IAA contends that "[t]he proposed statutory changes would impose an unnecessary and costly new layer of regulatory bureaucracy for investment advisory firms." Meanwhile, supporters of the Blueprint, including many in the financial services industry, argue that the adoption of a flexible core principles regulatory philosophy is vital in order to keep pace with the rapidly evolving financial markets. They point out further that the current U.S. model of having separate regulators covering similar territory is an impediment to global competition.

While both sides continue to debate the merits of the Blueprint, it is important to remember that the recommendations proposed by the Blueprint are just that, recommendations. It is almost a certainty that the Blueprint will undergo a series of changes as any plan to overhaul the U.S. commodities and securities markets will extend over several years and require the approval of Congress. It is also very likely that the future of financial market regulation in the U.S. will bear no resemblance at all to the Blueprint. In any event, the Blueprint's recommendation for regulatory consolidation of the commodities and securities markets will likely spur healthy debate in the coming years. Treasury Secretary Henry Paulson has issued an invitation for a substantive dialogue, saying that "the realities of the current marketplace for securities and futures products make it increasingly difficult to rationalize a separate regulatory regime."

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