Commodity Exchange Legislation in Serbia: Should It Be Separated From or Consolidated with the Capital Market Law? – Advisory Brief Including Experience in the U.S.

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Introduction

Serbia's New Capital Market Law provides a comprehensive regulatory framework for "financial instruments," which includes *inter alia* "options, futures, swaps and other derivative financial instruments relating to commodities." Capital Market Law, Art. 2. Given the inclusion of futures and other financial derivatives within the definition of financial instrument, a question arises as to whether a separate law for derivatives is necessary or even desirable. Such a question raises profound legal and policy issues relating to the fundamental purpose of financial regulation in the first place. It also raises issues that have been resolved in a variety of ways by different countries. In this paper, I will attempt to provide a framework for addressing this question based upon the experience in the U.S.

Unified Regulation

From a legal perspective, it is possible, even commonplace, to subject all manner of financial instruments to a single body of law administered by a single regulatory authority, as the New Capital Market Law has done. This unified regulatory approach is similar to the one that was the one adopted by Britain when it enacted the Financial Services and Markets Act 2000, which like the New Capital Market Law, encompasses futures, options, and other derivatives within a broader definition of financial instrument, and which subjects all financial services to a single regulator, the Financial Services Authority.

There are certain advantages in such a unified approach. It is obviously easiest for regulated entities involved in *heterogeneous* financial transactions if there is only one regulator and one set of rules to which they can look. It also does away with the need for different regulators, *e.g.*, securities regulators and futures regulators, to engage in extensive on efforts to coordinate and cooperate with other domestic financial regulatory agencies. More important, it avoids the jurisdictional conflicts that beset financial regulators in the U.S. for products that overlap the jurisdictional boundaries of different regulatory authorities

Notwithstanding these advantages, there are corresponding disadvantages that have influenced others, including the U.S. to opt for a different model. Not the least of these disadvantages is that such an approach may not adequately address or take into account the different purposes and functions served by different financial products.

Separate Regulation

At the other extreme, is the model followed by the United States, which subjects various financial instruments and intermediaries to distinct and separate bodies of law with corresponding regulators for each type depending upon the type of financial instrument. Thus, in the U.S. there are separate bodies of law and separate regulators for banking, securities, and derivatives products and their intermediaries. Indeed, in the U.S. not only does the CFTC have jurisdiction over futures transactions and other derivatives, it has "exclusive" jurisdiction over them to the exclusion of other regulators. The regulatory approach of the U.S. is often referred to as one based upon "functional regulation."

Functional regulation as practiced in the U.S., whereby regulatory agencies oversee different functional areas, is said to facilitate consistency in regulation (at least in the affected financial market sphere), and avoids the potential need for regulatory agencies to develop expertise in all aspects of financial regulation. Indeed, notwithstanding periodic calls to consolidate regulation across market sectors, by merging the Commodity Futures Trading Commission ("CFTC") with the Securities Exchange Commission ("SEC"), Congress has consistently chosen to retain and build upon the functional regulation approach, "one that has worked well for the United States and . . . has helped promote the competition and innovation that is a 'hallmark' of the U.S. financial system." Government Accounting Office, *Financial Regulation*, Report to the Chairman, Committee on Banking, Housing, and Urban Affairs, U.S. Senate (Oct. 2004), at 132.

Under this uniquely American functional approach to financial regulation, different regulatory agencies regulate different areas of the financial sector. Thus, while the CFTC regulates commodity futures, options, and swaps, other agencies, such as the SEC, banking regulators and insurance regulators regulate securities (including security-based swaps), banks, and insurance companies, respectively. Similarly, while the CFTC regulates commodity pools, futures commission merchants, commodity trading advisers, and other intermediaries closely connected with the futures and derivatives markets, the SEC regulates mutual funds, investment companies, broker-dealers, and investment advisers, while bank and insurance regulators oversee firms and agents operating in their spheres.

"While this approach may seem unduly complex to outsiders," as former Acting Chairman of the CFTC Sharon Brown-Hruska observes, it also "recognizes real differences between the sectors and a legitimate need for each regulator to possess a keen knowledge and understanding of the financial sector that they are assigned to regulate . . . and permit[s] many different types of financial products to develop and flourish." Remarks of Acting CFTC Chairman Sharon Brown-Hruska, *Market Competition and Regulatory Cooperation: A New Dynamic in US-EU Financial Relations*, Center for European Policy Studies, Brussels, Belgium (May 24, 2005).

According to Brown-Hruska, "[t]his type of regulation has permitted many different types of financial products to develop and flourish and has permitted agencies to focus on the development of new markets that could be overwhelmed if they were part of a broader remit within a single agency." *Id.* She also observes that the U.S. system permits regulators "to focus on the development of new markets that could be overwhelmed if they were part of a broader remit within a single agency," and that it "introduces a bit of healthy competition amongst the U.S. regulatory agencies . . . [and] foster[s] innovation and cost efficiencies." *Id.*

Serbia's New Capital Market Law and the Harmonization of Regulation

Under Serbia's New Capital Market Law, transactions in futures and over-the-counter derivatives are treated in the same manner as securities. For example, the prohibition of insider trading, a legal concept that in the U.S. is reserved exclusively for securities transactions in the United States, is applied to derivatives transactions taking place on commodity futures exchanges and over-the-counter under the New Capital Market Law. Similarly, the prohibition of manipulative conduct under the New Capital Market Law is based upon securities law principles, which are then transplanted to the derivatives context by the New Capital Market Law without any adjustments for differences between the two financial sectors.

This harmonization of regulation between the futures and derivatives market and the securities market, however, fails to reflect important core differences between those markets, which according to the CME Group, the leading future exchanges in U.S., "arise directly out of the differences between securities markets, which support capital formation, and futures markets, which exist to discover prices." *CME Group Statement on U.S. Treasury Department Blueprint for Financial Regulatory Reform* (Mar. 31, 2008), *available at the following link:*

http://investor.cmegroup.com/common/mobile/iphone/releasedetail.cfm?releaseid=302188&CompanyID=CME&mobileid.

The danger with a consolidated approach, according to this view, is that you end up with "an overly homogenized, less effective and less competitive model" for regulating the financial services sector." *Id.* As the CME Group put in response to a plan that then Secretary of Treasury Henry M. Paulson advanced in 2004 that would have harmonized financial regulation between different market sectors:

> Oversimplification of margining systems, customer protection regimes and regulatory philosophies across different types of markets, financial instruments, customers, geographies and regulators would likely reduce the quality of our systems of market regulation, market integrity and customer protection while also impairing our ability to meet the competitive demands of each sub-segment of our very diverse financial services marketplace.

Economic Rationale For Separate Regulation

The rationale for separate regulation of securities and derivatives in the U.S. is based upon fundamental differences in purpose served by the securities and commodity futures markets. In contrast to the securities markets, whose purpose centers on capital formation, the purpose of the commodity futures and derivatives markets is to provide a forum for price discovery and risk management. The capital formation function of securities is considered distinct from the purpose of commodity derivatives and other financial assets, which are primarily used for price discovery and risk management. These differences are reflected in the different regulatory philosophies and different regulatory regimes for securities and derivatives in the U.S.

This divergence can be illustrated by how three issues are handled in the U.S.—margin, manipulation, and insider trading—depending upon the context in which they arise.

Margin. In a securities transaction, margin serves as collateral against an extension of credit from the broker carrying the account. By contrast, margin in connection with a futures transaction may be said to serve as a good-faith deposit or performance bond to cover adverse movements in futures prices. The difference originates from the executory nature of futures contracts in which assets do not change hands until both parties to the transaction fully perform their respective obligations under the contract. This contrasts with a securities transaction, which involves a contract that is fully performed at origination. Thus, margin in the futures markets serves a different role than it does in the securities markets, which can be summed up as follows: "To the SEC, 'margin' is a down payment, while to the CFTC it is a security deposit." *Letter from Daniel J. Roth, President NFA to Treasury Secretary Henry Paulson, Re: Review by the Treasury Department of the Regulatory Structure Associated With Financial Institutions (Nov. 20, 2007)*. Given, this divergence in purpose, one could argue that it does not make sense to regulate margin in the futures markets in the same manner that it is regulated in the securities market.

Manipulation. In the futures markets, manipulation historically has focused on conduct that creates an "artificial" price, artificial in the sense that it did not represent the actual supply and demand of the cash market. Whereas no apparent fraud may have occurred between counterparties, the concern is that prices set in the futures markets may be able to affect the prices of cash transactions, and thus manipulated prices are viewed as a kind of "fraud on the market."[1] By contrast, manipulation in the securities context primarily focuses on whether parties to a transaction have engaged in fraud. Thus, whereas both the CFTC and the SEC have express prohibitions of manipulation in their authorizing statutes, their purposes are somewhat different, with the CFTC's premised on protecting the normal operations of the markets from abuse, while the SEC's provision is based more on protecting the ultimate customer. With the advent of Dodd-Frank legislation, which incorporated principles from the SEC concept of fraud-based manipulation and engrafted them on the CEA, however, these differences no longer are significant.

Insider Trading. In contrast to the broad prohibition against insider trading found in the securities laws, insider trading is considered an accepted and integral practice in the commodity futures and derivatives markets. Not only does the Commodity Exchange Act ("CEA") lack a prohibition against insider trading in commodities (except with respect to certain individuals connected with the regulation, self-regulation, or exchange governance of those markets), but the CEA actually accepts insider trading as a means to facilitate efficient pricing of commodities.[2] As with margin, this divergence in regulatory treatment in the two markets is due to fundamental differences between the securities and commodity futures markets. In contrast to the premise within securities law that investors should have equal access to material market information and that corporate insiders owe a fiduciary duty to shareholders, there is no similar expectation in the commodity futures and derivatives markets that market participants have, or even should have, equal access to nonpublic information, or that corporate officials and personnel have a similar fiduciary duty with respect to their counterparties. Indeed, the *raison d'etre* for trading in the commodity futures and derivatives markets is to do so based on information that traders have generated in their research, asset selection and liquidity management. As the CFTC has recognized, "it would defeat the market's basic economic function—the hedging of risk—to question whether trading on knowledge of one's own position were permissible."[3]

Policy Concerns

Ultimately, the choice of a regulatory model—whether unified, separate, or something in-between is a policy call based upon the purpose of different financial markets and the economic rationale for regulation of such markets. One can identify at least three principal theoretical concepts that drive the regulation of futures and derivatives in the U.S. based on notions (i) of the significance of consistency, that there should be only one regulator *for a particular transaction*, which will create legal certainty; and (ii) that a "derivative" is fundamentally different from the asset to which the derivative relates, so that it is beneficial to separate the regulation of the trading in an asset (which should be regulated by a government agency expert in that asset type) from the trading in the related derivative (which should be regulated by the CFTC as an expert in derivatives); and (iii) that "derivatives" are a limited product type that can be defined and walled off from the assets to which they relate.

Obviously, one can take issue with any of these three notions. While the first has the advantage of subjecting regulated entities involved in *homogeneous* financial transactions to one regulator and one set of rules for most transactions, it does not shield them from being subjected to more than one regulator when the transaction overlaps regulatory jurisdictions, such as when the transactions involve hybrid derivative products, where the lines between "functional" regulators are blurred.

As for the second and third concepts, there are those who argue, like Cadwalader partner Steven Lofchie, that a securities derivative is really not so different from a security that regulation of the securities derivative should be by a specialized derivatives regulator rather than to the SEC. Under this reasoning, while there is merit to the having an agency with specialized expertise in the regulation of trading (which perhaps argues for the CFTC to have authority over the trading of certain energy and agricultural products to the exclusion of other branches of government), it is hard to see the argument that the SEC does not have expertise in the regulation of trading markets. Thus, while separate regulation is also preferable to consolidated regulation, the dividing line under this view should be based on the underlying transaction, *i.e.*, subjecting any transaction involving a security to regulation by a securities regulator whether or not the transaction involves a derivative.

Therefore there appear to be three regulatory models to consider. The first, which is the one that appears to underlie Serbia's New Capital Market Law, involves consolidated regulation of securities and derivatives under one set of rules and one regulator. Such an approach, for example, treats insider trading the same whether it occurs in the securities or derivatives markets. The second approach, which is that currently applied in the U.S., involves compartmentalizing regulation based on function or type of financial transaction. Under this approach, transactions involving securities are regulated by the SEC, while derivatives are regulated by CFTC, whether or not the derivatives pertain to securities. The third approach, would also involve separate regulatory regimes, but be based upon the underlying nature of the transaction, and therefore, would subject all securities-related transactions to the authority of a securities regulator whether or not they involved derivatives. Which one to choose ultimately is a policy judgment call based upon one's view of the economic rationale for regulation.