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SELF-REGULATION IN THE FUTURES INDUSTRY

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Self regulation has a long history in the futures industry that predates the involvement of the federal government in the futures markets. In 1859, the Chicago Board of Trade formalized its self-regulatory powers and its founding charters, nearly 60 years before the federal government began to directly regulate the futures markets. Over time, however, Congress established a statutory system of self-regulation by exchanges or designated contract markets (“DCMs”) combined with government oversight to promote “responsible innovation and fair competition among boards of trade, other markets and market participants.” *CEA Sec. 3(b)*.

Under this regime, the Commodity Futures Trading Commission (“CFTC”) provides government oversight for the entire industry, while each futures exchange operates as a self-regulatory organization (“SRO”), governing its floor brokers, traders and member firms. In addition, the Commodity Exchange Act also authorizes the creation of “registered futures associations,” giving the futures industry the opportunity to create a nationwide self-regulatory organization. In 1981, the creation of such an organization was realized when the CFTC granted registration to the National Futures Association (“NFA”) as a self-regulatory futures association, which began operations a year later. Although the various regulatory organizations in the futures industry have their own specific areas of authority, together they form a regulatory partnership that oversees all industry participants.

In the futures industry, exchange SROs have responsibility for establishing and enforcing rules governing member conduct and trading; providing for the prevention of market manipulation, including monitoring trading activity; ensuring that futures industry professionals meet qualifications; and examining members for financial strength and other regulatory purposes. The NFA in turn regulates every firm or individual who conducts futures trading business with public customers. Finally, the CFTC independently monitors, among other things, exchange trading activity, large trader positions, and certain market participants’ financial conditions, and reviews appeals of final SRO disciplinary proceedings.

Over time, more regulatory responsibilities previously associated with the CFTC have been delegated to NFA. Amendments made to the CEA in 1978, for example, authorized the NFA to promulgate rules mandating membership for those conducting futures business with the public. Those amendments, and others passed in 1982, permitted the CFTC to delegate registration functions to the NFA in order to alleviate the CFTC’s regulatory burden and reduce registration delays.

In enacting the Commodity Futures Modernization Act of 2000 (“CFMA”), Congress expressly reaffirmed this “system of effective self-regulation” governing the futures industry. The CFMA encouraged the development of “best practices.” Allowing the industry and self-regulatory organizations, rather than the CFTC, to develop their own standards and guidelines was thought to better promote the practices reflective of the marketplace. The CFTC ultimately retains the authority to approve such practices, but the genesis for such guidelines is derived from the marketplace rather than the traditional top-down regulatory structure. At the same time

that the CFMA reaffirmed the importance of self-regulation, however, it also recognized the tension inherent in such a system of governance with the inclusion of Core Principle 15, which requires exchanges to “minimize conflicts of interest in decision-making and establish a process for resolving such conflicts of interest.”

It was partly in recognition of that tension and partly in response to industry changes, most notably the movement to transform SROs into for-profit commercial enterprises, that the CFTC in 2003 decided to commence a major review of the role of self-regulation in the futures industry and how best to structure SROs in the context of a changing financial marketplace. That review, which occurred over a three-and-a-half year span, culminated in “the Commission’s firm belief effective self-regulation in an increasingly competitive publicly traded, for-profit environment requires independent decision making at key levels of DCM’s regulatory governance structures.”

Accordingly, the CFTC in February 2007 adopted “Acceptable Practices” applicable to all DCMs focusing on structural conflicts of interest of such organizations and offering them a safe harbor by which they may minimize such conflicts and comply with Core Principle 15. Of the four-part acceptable practices, the most important element included requiring SRO governing boards to be composed of at least 35% independent, public directors, with strict criteria for what would constitute “public” for the purposes of the safe harbor. In articulating a rationale for this rule, the CFTC noted that “[a]n SRO is not simply a corporation, but a corporation charged with the public trust” with responsibilities both as a regulator of its market and members and as a commercial entity with commercial incentives embedded in its market operation. In particular, the CFTC pointed to “[t]he presence of . . . potentially conflicting demands within a single entity—regulatory authority coupled with commercial incentives to misuse such authority—constitutes the new structural conflict of interest addressed by the acceptable practices” that the CFTC was adopting. *72 F.R. 6936, 6937 (Feb. 14, 2007) (Final Rule)*.

Although this rationale comported with the findings of academic law and economics literature, see *Jonathan Macey and Maureen O’Hara, From Markets to Venues: Securities Regulation in an Evolving World*, 58 *Stand. L. Rev.* 563 (2005) (noting the “paradoxical situation” where those who are in charge of self-regulation are being regulated by, and are regulating, their competitors and that “every time an exchange issues a rule that affects its competitors, it has a conflict of interest”), it met with fierce resistance from the exchanges who argued *inter alia* that the action by the CFTC was inconsistent with the non-prescriptive spirit of the CFMA. It also met resistance within the Commission itself, with the original public director standard for boards of directors reduced from the 50% of the original proposal to 35% in the final rule. Ultimately, the effort failed with the announcement in November 2007 that the Acceptable Practices were being stayed until further notice due to the CFTC’s inability to clarify the definition of “public director.”