The University of New Hampshire Law Review

Volume 3
Number 1 *Pierce Law Review*

Article 4

December 2004

Examining the Merits of Dual Regulation for Single-Stock Futures: How the Divergent Insider Trading Regimes for Federal Futures and Securities Markets Demonstrate the Necessity for (and Virtual Inevitability of) Dual CFTCSEC Regulation for Single-Stock Futures

Zachary T. Knepper
Georgetown University

Examining the Merits of Dual Regulation for Single-Stock Futures: How the Divergent Insider Trading Regimes for Federal Futures and Securities Markets Demonstrate the Necessity for (and Virtual Inevitability of) Dual CFTC-SEC Regulation for Single-Stock Futures

ZACHARY T. KNEPPER*

I. INTRODUCTION

Single-stock futures are a recent addition to the financial landscape in the United States and provide retail and institutional investors with a new tool for investment or speculation. So far, the market response to these instruments has been cool. Some observers have argued that the regulatory framework for single-stock futures is a cause of the lack of investor interest. Single-stock futures are regulated by both the Commodities Futures Trading Commission ("CFTC") and the Securities and Exchange Commission ("SEC"), and this system of dual regulation has been criticized as overly burdensome and unnecessary.

This paper supports the current system of single-stock futures regulation. Specifically, this paper argues that dual regulation of single stock futures is necessary because the United States has divided commodities and securities regulation between two federal agencies while single-stock futures have one foot squarely in each camp. There are many issues that demonstrate the necessity for dual regulation, but this paper relies primarily on insider trading to argue the point. Although it is clear that market interest in single-stock futures has so far been limited, this paper asserts that Congress should avoid making any radical changes to the dual-regulatory regime and instead should allow the market to develop under the current system.

* B.S., United States Military Academy, 1995; J.D., University of Illinois College of Law, 2003; LL.M., Georgetown University Law Center, 2004. The author is an associate in the Washington, D.C. office of Fried, Frank, Harris, Shriver & Jacobson LLP and wrote this paper as part of an LL.M. program in Securities and Financial Regulation at Georgetown University. The opinions expressed herein are those of the author and do not necessarily reflect the opinions of Fried Frank, its attorneys, or clients.

II. BACKGROUND ON SINGLE-STOCK FUTURES

Futures are contracts to buy or sell a specific quantity of some asset at a specified price and date in the future.[1] "Futures" are thus simply contracts for the future delivery of something (such as a commodity; wheat for instance), and the underlying asset upon which a future is based can theoretically be anything that can be bought or sold. In this way, futures are derivatives - that is, their value derives from the underlying asset upon which they are based.

Futures trading and the futures markets in the United States are regulated by the Commodities Futures Trading Commission by operation of the federal Commodities Exchange Act ("CEA").[2] The CEA does not actually define the term "futures," but instead makes the term meaningful through operation of the statute.[3] Specifically, the CFTC has authority from Congress to regulate all "contracts of sale of a commodity for future delivery."[4] Thus, anything that qualifies as a "commodity" and that is traded by a contract for future delivery falls under the CFTC's purview. Since Congress defined the term commodity broadly under the statute, virtually anything traded for future delivery can potentially become subject to CFTC regulation.[5]

Based on the breadth of the term "commodity" under the CEA, it follows that a contract for the future delivery of a *security* would fall within the CFTC's responsibility as well. In the 1970s, this was a point of contention between the CFTC and the Securities Exchange Commission, which is responsible for regulating the securities markets.[6] Conflict over the regulation of securities futures came to a head in 1982 in *Board of Trade of the City of Chicago v. SEC*, wherein the Seventh Circuit Court of Appeals determined that securities futures regulation was properly the province of the CFTC by the terms of the Commodities Exchange Act.[7] In response to this ruling and to settle jurisdictional questions over securities futures, the SEC

1. *See e.g.* Kennedy Mitchell, *Single Stock Futures: An Investor's Guide* 215 (John Wiley & Sons 2002).

2. *See* 7 U.S.C. § 2(a)(1) (2000) ("The Commission shall have exclusive jurisdiction . . . with respect to accounts, agreements . . . and transactions involving contracts of sale of a commodity for future delivery, traded or executed on a contract market designated or derivatives transaction execution facility registered pursuant to section 5 or 5a or any other board of trade, exchange, or market, and transactions subject to regulation by the Commission pursuant to section 19 of this Act.").

3. *See generally* 7 U.S.C. § 1(a) (2000) (definitions section of the Commodities Exchange Act).

4. 7 U.S.C. § 2(a)(1)(A).

5. *See Bd. of Trade of the City of Chi. v. SEC*, 677 F.2d 1137, 1142 (7th Cir. 1982).

6. *E.g. CFTC and SEC: Issues Related to the Shad-Johnson Jurisdictional Accord, Government Accounting Office Report to Congressional Requesters*, GGD-00-89 at 5 (April 2000) (available at http://www.gao.gov/new.items/gg00089.pdf) (hereinafter "GAO Shad-Johnson Report").

7. *See Bd. of Trade*, 677 F.2d at 1155-59.

and the CFTC approached Congress with a proposed regulatory agreement known as the Shad-Johnson Accord, which was enacted into law in 1982. Shad-Johnson trifurcated securities futures and options regulation: the SEC would regulate securities-based options, the CFTC would regulate futures of broad-based stock indexes and government securities, and futures on single stocks and narrow-based stock indexes would be prohibited.[8] This prohibition on single-stock futures and narrow-based stock index futures was intended to be temporary.[9]

Futures on single stocks or narrow-based stock indexes are known collectively as "single-stock futures." (Narrow-based stock indexes—a stock index containing only a handful of stocks—are included within the term "single-stock futures" because these indexes can approximate the value of a single-stock within the index and thus serve as a proxy for an individual security.)[10] Congress prohibited single-stock futures in 1982 because of the SEC's concern that these instruments could be used to manipulate the securities markets.[11] Specifically, Congress accepted the SEC's concern that single-stock futures act as a very close substitute for the securities upon which they are based (because the futures contract is simply a form of delivery of the security)[12] and therefore the regulation of single-stock futures must be made consistent with the overall framework of federal securities regulation.[13] Given the Seventh Circuit's determination that single-stock futures are *futures* to be regulated by the CFTC,[14] Congress decided to prohibit these instruments pending a review by the CFTC and SEC on how to properly regulate them. This review never happened, however, and the temporary ban on single-stock futures enacted through the Shad-Johnson Accord became permanent.

III. THE CURRENT REGULATORY REGIME

The ban on single-stock futures lasted until December 2000, when Congress lifted it as part of the Commodities Futures Modernization Act of

8. *See e.g.* David B. Esau, Student Author, *Joint Regulation of Single Stock Futures: Cause or Result of Regulatory Arbitrage and Interagency Turf Wars?*, 51 Cath. U.L. Rev. 917, 921-22 (2002).
9. GAO Shad-Johnson Report, *supra* n. 6, at 6.
10. *See e.g.* William J. Brodsky, *The Globalization of Stock Index Futures: A Summary of the Market and Regulatory Developments in Stock Index Futures and the Regulatory Hurdles Which Exist for Foreign Stock Index Futures in the United States*, 15 Nw. J. Intl. L. & Bus. 248, 290 (1994).
11. *See id.*; *see also* GAO Shad-Johnson Report, *supra* n. 6, at 7.
12. *See e.g.* Annette Nazareth, *Testimony Concerning H.R. 4541, The Commodity Futures Modernization Act of 2000*, http://www.sec.gov/news/testimony/ts132000.htm (July 19, 2000).
13. *See generally* H.R. Rpt. 106-43 (Feb. 15, 2000) (available at http://commdocs.house.gov/committees/ag/hag10643.000/hag10643_0f.htm) (accessed Dec. 5, 2004).
14. *See Bd. of Trade*, 677 F.2d at 1142.

2000 ("CFMA"). The CFMA was a major overhaul of the commodities and securities laws[15] and had three principal goals: to create legal certainty for over-the-counter derivative transactions; to repeal the ban on single-stock futures; and to provide regulatory relief for futures exchanges.[16] The CFMA was prompted by concerns among regulators (and Congress) that if the United States did not improve its legal treatment of derivatives, the market for these instruments would simply flow overseas to foreign exchanges and a significant part of American economic activity would thus be imperiled.[17] The repeal of the ban on single-stock futures was not central to the purpose of protecting American futures markets (other aspects of the CFMA were aimed at that objective),[18] but instead was added to the CFMA because the ban was perceived as an unnecessary barrier to market activity. So long as suitable regulation could be achieved, Congress determined to allow trading of single-stock futures.[19] The question, therefore, was how best to regulate these instruments.

Ultimately, Congress opted for dual regulation of single-stock futures. The merits of dual regulation are discussed in detail in Part IV of this paper, however, briefly stated, dual regulation arose because Congress accepted that both the SEC and CFTC had compelling regulatory interests in single-stock futures.[20] For instance, Arthur Levitt, former Chairman of the

15. For example, a printout of the CFMA runs to over 100 pages. *See Commodity Futures Modernization Act of 2000*, Pub. L. No. 106-554, 114 Stat. 2763A-365 (Dec. 14, 2000) (incorporating H.R. 5660 into Appendix E).

16. *See* H.R. Rpt. 106-711(III) at 45 (Sept. 6, 2000) (available at 2000 WL 1279131).

17. *See e.g. id*. at 45-48; *see also* H.R. Rpt. 106-43 at 10 (recounting statement of Alan Greenspan, Chairman of the Federal Reserve, on need for updates to futures and derivatives regulation: "Already the largest futures exchange in the world is no longer in America's heartland. Instead, it is in the heart of Europe. To be sure, no U.S. exchange has yet to lose a major contract to a foreign competitor, but it would be a serious mistake for us to wait for such unmistakable evidence of a loss of international competitiveness before acting.").

18. For instance, lifting the legislative ban on single-stock futures had no bearing on the main CFMA issues of providing predictability for swaps transactions and other over-the-counter derivatives or for re-authorization of the CFTC. This is reflected in some of the testimony before Congress. *See e.g.* H.R. Rpt. 106-711(III) at 91 (dialogue between Rep. Thomas Ewing and Mr. William Brodsky, Chairman of the Chicago Board Options Exchange). These other derivatives issues were vastly more important for futures markets. *E.g.* John P. Davidson, *Operations Issues for U.S. Single Stock Futures*, 21 No. 4 Futures & Derivatives L. Rep. 1 (June 2001).

19. *See e.g.* H.R. Rpt. 106-711(III) at 47-48.

20. For example, the President's Working Group on Financial Markets, composed of the leaders of the Treasury, Federal Reserve, SEC, and CFTC, described the regulatory issues this way:

> From the perspective of the securities laws, the issues raised by trading of single-stock futures include levels of margin, insider trading, sales practices, real-time trade reporting, and activities of floor brokers, as well as the exclusive jurisdiction of the CFTC over futures contract markets. From the perspective of the commodity futures laws, the issues raised by these instruments include clearing, segregation, large trader reporting, and direct surveillance. . . . [T]he Working Group unanimously recommends that these agencies work to-

Securities and Exchange Commission, defended the SEC's need to be involved in single-stock futures regulation: "Some might dismiss [the SEC's concerns over single-stock futures] as a guise for protection of turf. I assure you, the questions surrounding how best to ensure that regulatory disparities do not erode investor confidence are profoundly serious."[21]

The CFTC and SEC conducted months of inter-agency dialogue concerning how to manage dual regulation of single-stock futures,[22] and Congress ultimately embraced the following regulatory principles. First, single-stock futures would be recognized as *futures* and the CFTC's statutory authority under the CEA as the sole futures regulator was amended to provide that the SEC would share jurisdiction over single-stock futures.[23] The SEC was then given authority to regulate single-stock futures through amendments to the definition of "security" under the securities laws (although the SEC's authority only extends to single-stock futures, not 'broad-based' security futures, which remain the province of the CFTC exclusively).[24] Second, single-stock futures were made tradable on either futures exchanges or stock exchanges (provided that the exchange registered with both the CFTC and SEC and picked a primary regulator),[25] while the exchanges could use any approved clearing agency[26] to settle trades either physically or through cash settlement.[27] Third, the CFMA authorized the Federal Reserve Board to set margin levels for single-stock futures (though the Federal Reserve Board delegated this to the SEC and CFTC to determine, as allowed under the CFMA).[28] Finally, and most importantly, the CFMA provided for shared enforcement of single-stock securities futures rules. Thus, if there is a rule violation or a fraud in the

---

> gether and with Congress to determine whether the trading of single-stock futures should be permitted and if so, under what conditions.

Over-the-Counter Derivatives Markets and the Commodity Exchange Act, Report of the President's Working Group on Financial Markets at 32 (Nov. 1999) (available at http://www.treas.gov/press/releases/reports/otcact.pdf) (accessed Dec. 5, 2004) (hereinafter "President's Working Group Report").

21. Michael Schroeder, *Deals & Deal Makers: Lugar in Senate Charges CFTC, SEC Impede Bill to Deregulate Derivatives*, Wall St. J. C26 (June 22, 2000) (quoting statement by former SEC Chairman Arthur Levitt's, before Congress).

22. *E.g.* William J. Rainer, *Testimony of William J. Rainer, Chairman of the Commodities Futures Trading Commission, Before the Senate Committee on Banking, Housing, and Urban Affairs,* http://www.cftc.gov/opa/speeches00/oparainer-5.htm (last updated Feb. 1, 2001).

23. *See Commodities Futures Modernization Act of 2000* at § 251.

24. *See id.* at § 201.

25. *See id.* at §§ 202, 251.

26. *See id.* at §§ 112, 206.

27. *See id.* at § 206.

28. *See id.*; *see also Letter from Jennifer J. Johnson, Secretary of the Federal Reserve Board, to James E. Newsome, Acting Chairman, CFTC, & Ms. Laura Unger, Acting Chairman, SEC*, in 66 Fed. Reg. 50720, 50741 (Oct. 4, 2001).

sale of a single-stock future, either the CFTC or the SEC may initiate an enforcement action, provided it notifies the other agency.[29]

This quick sketch of the dual regulatory regime demonstrates that it is interconnected with the federal statutes that the CFTC and SEC operate under and that these agencies must interact in the regulation and enforcement of single-stock futures. It clearly would be much simpler if there were only one regulator, and single agency regulation would be preferable if at all possible. Many market participants apparently feel this way and view dual regulation as cumbersome and dangerously over-regulatory.[30] Yet as will be demonstrated in the next part of this paper, dual regulation is an unfortunate necessity because of America's division of commodities and securities regulation into two separate federal agencies with distinct mandates.

IV. WHY DUAL REGULATION IS REQUIRED AND APPROPRIATE

It is difficult to find any fans of the dual regulatory regime. In addition to the Chairman of the Chicago Board Options Exchange,[31] two law review notes criticize dual regulation as a flawed legal regime that creates as many problems as it solves.[32] These criticisms are not unreasonable. Dual regulation adds costs, both to market participants (in terms of determining how best to comply with potentially confusing or contradictory regulation) and to regulators (in terms of the energy needed for inter-agency coordination of rule drafting and enforcement actions). But such concerns miss a central point in single-stock futures regulation: some form of dual regulation was virtually inevitable because it is necessary to avoid regulatory arbitrage and to protect the integrity of domestic securities markets.

Dual regulation of single-stock futures is required because the United States has bifurcated futures and securities regulation between two separate federal agencies. The CFTC and SEC have different areas of responsibility and, in the context of single-stock futures, both have important and legitimate regulatory concerns. First, it would appear self-evident that the CFTC should be involved in the regulation of single-stock futures. Futures

---

29. *See Commodities Futures Modernization Act of 2000* at §§ 204, 251.

30. *See e.g.* William J. Brodsky, *New Legislation Permitting Stock Futures: The Long and Winding Road*, 21 Nw. J. Intl. L. & Bus. 573, 584 (2001).

31. *See id.*; *see also* Isabelle Clary, *Slow Start Seen for Single-Stock Futures*, http://www.pfgbest.com/traders_tools/e_securities.pdf. (Aug./Sept. 2001) (statement of William Brodsky, Chairman of the Chicago Board Options Exchange, describing dual regulation as "a challenge").

32. See Sanford A. Fine, Student Author, *Back to the (Single Stock) Future: The New Regulatory Framework Governing Single-Stock Futures Trading*, 54 Admin. L. Rev. 513, 530-33 (2002); Esau, *supra* n. 8, at 950.

regulation is what the CFTC does and to remove the agency from an ongoing role in single-stock futures regulation would undermine its very purpose and acknowledged expertise in futures regulation.[33] Second, the SEC has a compelling interest in single-stock futures regulation because single-stock futures can act as a surrogate for their underlying securities.[34] To have consigned single-stock futures regulation to the CFTC alone would potentially undermine the integrity of the securities markets. There is simply no getting-around the basic necessity for dual regulation.

This conclusion is reflected in a report of the President's Working Group on Financial Markets. The President's Working Group is an informal association of the four chairmen of the Treasury Department, the Federal Reserve Board, the Securities and Exchange Commission, and the Commodities Futures Trading Commission. In November 1999, the Working Group published a report on proposed modifications to the Commodities Exchange Act, including recommendations with respect to single-stock futures.[35] In their report, the four chairmen recommended that Congress repeal the prohibition on single-stock futures if concerns of market integrity and regulatory arbitrage could be resolved.[36] The Working Group did not explicitly recommend any form of regulation, but suggested that dual regulation might be required due to the important securities and futures issues involved.[37] The Working Group listed the following specific concerns:

> From the perspective of the securities laws, the issues raised by trading of single-stock futures include levels of margin, insider trading, sales practices, real-time trade reporting, and activities of floor brokers, as well as the exclusive jurisdiction of the CFTC over futures contract markets. From the perspective of the commodity futures laws, the issues raised by these instruments include clearing, segregation, large trader reporting, and direct surveillance.[38]

It may reasonably be wondered whether these were legitimate legal/regulatory concerns or just a veneer for regulatory parochialism.[39] This

33. The reader will recall that, aside from the category of single-stock futures, the Commodities Exchange Act provides that the CFTC is to have "exclusive" jurisdiction over futures markets and futures regulation. *See supra* n. 2 and accompanying text.

34. *See supra* n. 12 and accompanying text.

35. *See* President's Working Group Report, *supra* n. 20, at 32.

36. *Id.*

37. *Id.*

38. *Id.*

39. It must be remembered that the chairmen of both the SEC and CFTC sit on the President's Working Group, and thus made recommendations in this report with respect to their own agencies.

paper now examines two of these issues, large trader reporting and insider trading, to demonstrate the practical necessity for dual regulation of single-stock futures.[40]

A. *Large Trader Reporting*

Large Trader Reporting is an issue in which CFTC and SEC regulations differ and that demonstrates the need for CFTC oversight of single-stock futures trading. Large trader reporting is significant in futures regulation, but not in the securities markets. To begin, the CFTC imposes "large trader reporting" on futures commission merchants, clearing members, and futures brokers.[41] Large trader reporting is basically a complex reporting system whereby the CFTC traces ongoing open market positions down to the level of beneficial ownership in order to maintain near-real-time monitoring of large, open positions in the futures markets.[42] The CFTC considers large trader reporting to be an essential tool in preventing price manipulation in the futures markets because, at any given time, as much as ninety percent of open market positions may be held by only a few large traders, giving these entities significant market power.[43] Due to the perceived importance of large trader reporting in the futures markets, the CFTC has insisted that these obligations be imposed on the trading of single-stock futures.[44]

There is no comparable system in the securities markets (although in the past the SEC has considered adopting such a system).[45] Instead, the securities markets are regulated through the Securities Act's and Securities Exchange Act's complex reporting and disclosure rules, suitability rules, antifraud protections, and like requirements. Assuming then that CFTC and SEC are correct in their respective views of the need for large trader

40. This paper assumes without deciding that current regulation of futures and securities markets is appropriate and, therefore, that a fundamental goal of single-stock futures regulation must be to make single-stock futures markets function effectively within the existing regulatory framework.

41. *See Reporting Levels for Large Trader Reports; Securities Futures Products*, 66 Fed. Reg. 64383, 64383 (Dec. 13, 2001).

42. *See* Commodities Futures Trading Commission, *CFTC's Large Trader Reporting System*, http://www.cftc.gov/opa/backgrounder/opa-ltrs.htm (last updated Oct. 3, 2001).

43. *See Reporting Levels for Large Trader Reports; TRAKRS*, 67 Fed. Reg. 64522, 64523 (Oct. 21, 2002) ("These market surveillance programs are designed to detect and to prevent market congestion and price manipulation and to enforce speculative position limits. They also provide information regarding the overall hedging and speculative use of, and foreign participation in, the futures markets and other matters of public interest.").

44. *See Reporting Levels for Large Trader Reports; Securities Futures Products*, 66 Fed Reg. at 64383.

45. *See e.g.* Jerry W. Markham, *Super Regulator: A Comparative Analysis of Securities and Derivatives Regulation in the United States, United Kingdom, and Japan*, 28 Brook J. Intl. L. 319, 346 n.134 (2003).

reporting in the futures and securities markets,[46] it follows that large trader reporting oversight by the CFTC should be a part of the regulation of single-stock futures. The CFTC has a system in place to monitor large trader reports (and futures participants understand this obligation) whereas the SEC has no similar institutional experience. More importantly, CFTC-regulated large trader reporting of single-stock futures is essential to maintaining consistency among futures regulation. *Not imposing* large trader reporting requirements on single-stock futures while requiring it of other futures markets would be dangerous: such a regulatory disparity would, other things being equal, undermine futures regulation by creating an incentive for capital to flow toward the less-regulated single-stock futures markets and away from the other (more highly-regulated) futures markets. Making single-stock futures regulation consistent with other futures regulation is thus a legitimate regulatory consideration.

B. *Insider Trading*

Large trader reporting is one issue (out of at least four identified by the President's Working Group)[47] that demonstrates why the CFTC needs to have a role in single-stock futures regulation. On the other hand, insider trading demonstrates a compelling reason for the SEC to be involved as well. In fact, insider trading perhaps as much as any issue demonstrates that dual regulation of single-stock futures is a practical necessity.

There is reasonable debate among academics and others as to whether insider trading (that is, trading on the basis of material[48] non-public information) should be prohibited in securities or futures markets and, if so, to what extent.[49] This paper does not take-up this question. Instead, this paper assumes that current insider trading rules in the securities and commodities markets are appropriate for each system. Based on this assumption, this paper then focuses on the disparities between these two regulatory schemes to argue that dual regulation of single-stock futures is made a practical necessity thereby.

---

46. *See* Brian P. Volkman, *Defining the Role of Commodities Regulators*, 19 N.Y.L. Sch. J. Intl. & Comp. L. 215, 238-39 (1999) (for a review of arguments that large trader reporting is an unnecessary burden on the marketplace).

47. For the specific issues raised, review the text accompanying *supra* note 38.

48. "Materiality" is a loaded term in both commodities and securities law, but generally has the same connotations. Basically, it means that certain information is important. CFTC Regulation 1.59 defines "materiality" as: "information which, if such information were publicly known, would be considered important by a reasonable person in deciding whether to trade a particular commodity interest on a contract market." *See* 17 C.F.R. § 1.59(a)(5) (2004). The securities laws have a similar standard. *See e.g. Basic Inc. v. Levinson*, 485 U.S. 224, 232 (1988).

49. *See e.g.* Kimberly D. Krawiec, *Fairness, Efficiency, and Insider Trading: Deconstructing the Coin of the Realm of in the Information Age*, 95 Nw. U. L. Rev. 443 (2001).

The SEC and CFTC have taken dramatically different regulatory stances with respect to the issue of insider trading. In the securities markets, insider trading is fraud. Specifically, a person violates Section 10(b) and Rule 10b-5 of the Securities Exchange Act,

> when he or she buys or sells securities on the basis of material, non-public information and at the same time is an insider of the corporation whose securities are traded, or [is] a tippee who knows or should know of the insider's breach of duty. The theory is that an insider owes a fiduciary duty to the corporation's shareholders not to trade on inside information for his personal benefit.[50]

Insider trading often involves complex factual situations, and insider trading cases can be categorized into at least three groups. First, a basic insider trading case can involve an employee's or fiduciary's trading company stock on the basis of material, non-public information in breach of a fiduciary duty to the shareholders of the company.[51] The essence of the securities fraud is the breach of fiduciary duty to the company's shareholders. Second, 'tipper-tippee' cases involve situations in which an insider breaches his fiduciary duties to a company by disclosing inside information about the company to another person and the 'tippee' then trades on the information, recognizing that the insider has violated a duty in disclosing the useful information. In these cases, the tipper and tippee my both be guilty of securities fraud.[52] A third type of insider trading case is a 'misappropriation' situation in which an outsider becomes aware of material non-public information about a company through work for a third party and breaches a duty to the third party, *i.e.*, misappropriates the information - by trading on it.[53] These three general categories of insider trading demonstrate that, under the securities laws, both insiders and outsiders of a corporate issuer can commit securities fraud in certain circumstances by trading on the basis of material non-public information.[54]

In contrast with the securities markets, insider trading is generally not prohibited in the futures markets.[55] The CFTC prohibits insider trading through its Regulation 1.59, but this only affects market professionals. For instance, the regulation prohibits brokers from trading ahead of a client (as

50. *SEC v. Cherif*, 933 F.2d 403, 408-09 (7th Cir. 1991).
51. *See e.g. U.S. v. Smith*, 155 F.3d 1051 (9th Cir. 1998); *cf. Chiarella v. U.S.*, 445 U.S. 222 (1980).
52. *See e.g. Dirks v. SEC*, 463 U.S. 646 (1983).
53. *See e.g. U.S. v. O'Hagan*, 521 U.S. 642 (1997).
54. Of course, the elements in an insider trading case are much more complicated than outlined here. However, this discussion demonstrates the point that insider trading liability potentially extends very broadly in the securities markets.
55. *See generally* Nina Swift Goodman, *Trading in Commodity Futures Using Nonpublic Information*, 73 Geo. L.J. 127 (1984).

otherwise the broker could deprive the client of a better price achieved by the broker's earlier trading) and restricts trading by market regulators (so as to prevent exchange employees from profiting on the basis of information acquired through their work at the futures exchange).[56] These situations are seen to involve breaches of fiduciary duties by market professionals to market participants.[57] Otherwise, though, there are no general prohibitions against market participants' trading on the basis of material nonpublic information. The CFTC has considered adopting insider trading prohibitions similar to those imposed through the securities laws, but has rejected the idea as unnecessary and undesirable.[58] The reasons for this include problems of policing insider trading by the CFTC[59] and the CFTC's limited view of fiduciary duty obligations in the futures marketplace.[60]

More generally, though, the divergent insider trading rules in the securities and futures markets reflects fundamentally distinct views on the nature of insider trading. Insider trading is not proscribed in the futures markets because, ultimately, trading on the basis of proprietary information is necessary to achieve market goals of providing pricing efficiency and hedging opportunities.[61] Market participants are not prohibited from trading on the basis of proprietary information because this is the basis for their economic motivation to enter the futures markets at all - that is, if market participants could not speculate or hedge, the fundamental purposes of the futures markets would be thwarted. Furthermore, the closest analogue to insider trading in the futures markets, trading by individuals who possess material information through a relationship with another market participant (*e.g.* an employee of a grain company trading in the futures markets based on his knowledge of the company's upcoming grain futures trades), is not proscribed even where there is a breach of fiduciary duty because the CFTC simply does not consider this to be a *market* problem.[62] The 'insider' may be defeating his employer's goals by taking advantage

---

56. *See* Jerry W. Markham, *'Front-Running'—Insider Trading Under the Commodity Exchange Act*, 38 Cath. U. L. Rev. 69, 94, 110 (1988) (discussing CFTC Regulation 1.59, 17 C.F.R. § 1.59 (2004)).
57. *Id.* at 106.
58. The CFTC issued a report to Congress in 1984 on the issue of insider trading in the futures markets in which the CFTC recommended against prohibiting the practice. *See* Commodity Futures Trading Commission, *A Study of the Nature, Extent and Effects of Futures Trading by Persons Possessing Material, Nonpublic Information* (Sept. 1984); *see also* Markham, *supra* n. 45, at 352 & nn. 171-72.
59. *See* Markham, *supra* n. 56, at 108.
60. *Id.* at 106.
61. *Id.* at 93-94.
62. *See id.* at 104-07.

of the inside information about its future trading activity, but the insider is not deceiving or manipulating the market, the CFTC's principle concern.[63]

The CFTC's approach to insider trading in the futures markets (which may appropriately be described as laissez-faire) thus differs markedly from the SEC's consideration of the issue.[64] This is an important point in single-stock futures regulation. For if the CFTC had been given sole responsibility for regulating single-stock futures, it would have had to either adopt the insider trading prohibitions contained in the securities markets or permit a significant disparity between securities regulation and single-stock futures regulation. Neither option is practicable.

First, the CFTC would have been hard-pressed to graft insider trading rules onto its regulation of single-stock futures. Insider trading rules in the securities markets are principally judge-made and it would be difficult to recreate the securities-law scheme under the Commodities Exchange Act or by CFTC rules. Furthermore, this would potentially require continuous updating by the CFTC to keep its rules for single-stock futures consistent with those of the securities markets. The CFTC might attempt to avoid this problem entirely through a blanket prohibition against insiders' trading their own companies' single-stock futures[65] (indeed, such a blanket prohibition would provide the most obvious protection against insiders illicitly profiting in the futures markets), however, such a prohibition would need to extend to the insiders' families and friends in order to avoid tipper-tippee situations. Policing such a rule would be extremely difficult for the CFTC, since it has no system to monitor such insider trading activity.

An alternative to the CFTC's adopting insider trading rules for single-stock futures regulation would be to avoid the issue by allowing insider trading in the market for securities futures. But this is equally undesirable - and surely politically impossible. Congress and the public would never tolerate a system whereby corporate executives are allowed to profit by trading single-stock futures based upon their knowledge of their company's upcoming activities. Because of the importance of insider trading regulation and the impracticability of regulating insider trading through the

63. *See id.* at 108.

64. Thomas C. Newkirk, Speech, *Speech by SEC Staff: Insider Trading – A U.S. Perspective* (Cambridge, England, Sept. 19, 1998) (available at http://www.sec.gov/news/speech/speecharchive/1998/spch221.htm) (accessed Dec. 5, 2004) (for an example of the SEC's view that insider trading is damaging to the securities markets and requires vigorous enforcement).

65. Congress could authorize the CFTC to completely proscribe insiders (employees, independent contractors, agents, etc.) from trading in the single-stock futures of their companies. For instance, such a prohibition ought not violate constitutional issues of substantive due process or equal protection because single-stock futures trading is not a fundamental right, and employment by or for a company does not create a protected class.

futures markets, the SEC therefore needs to be involved in single-stock futures regulation, and dual regulation is made a practical necessity.

C. *Regulatory Arbitrage*

The preceding discussion has touched on only two issues (among potentially many others)[66] that demonstrate the need for careful coordination of single-stock futures regulation between the CFTC and the SEC. Implicit in this discussion, though, has been another issue: the need to avoid "regulatory arbitrage." The concept of regulatory arbitrage ties together a number of threads in this paper and provides a theoretical foundation for understanding why dual regulation of single-stock futures is required.

Regulatory arbitrage is the process of taking advantage of divergent regulatory regimes that govern similar financial products so as to profit from disparities between the regulation of the products (either through reduced costs or increased income). "The numerous opportunities for regulatory arbitrage derive from a widely-understood, basic concept in modern finance: a party to financial transactions may use a variety of different trading strategies to achieve the same economically-equivalent position."[67] Because U.S. markets for securities and options on securities are robust, if the market for single-stock futures became subject to significantly less regulation (as are future markets generally), economic activity would flow away from the securities and options markets and toward the single-stock futures markets. Such a regulatory imbalance would undermine the purposes of securities regulation and would disrupt the financial markets.[68] Avoiding regulatory arbitrage is an important (even critical) issue in single-stock futures regulation.

V. DUAL REGULATION IN PRACTICE AND THE UNCERTAIN FUTURE

Single-stock futures began trading on two dedicated exchanges, OneChicago and Nasdaq-Liffe, in November 2002.[69] So far, they have not

66. The reader will recall that the President's Working Group on Financial Markets identified ten securities and commodities issues that it considered significant. Review the text accompanying *supra* note 38.

67. Frank Partnoy, *Financial Derivatives and the Costs of Regulatory Arbitrage*, 22 J. Corp. L. 211, 227 (1997).

68. This paper is not evaluating whether all the current regulations imposed on securities and options are *necessary*. Instead, this paper argues that because of the system we have created, dual regulation of single-stock futures necessarily follows.

69. *See* Bloomberg News, *Single Stock Futures Volume Falls as War Captures Investors' Focus*, Chi. Trib. C2 (May 4, 2003).

been very popular with investors.[70] For example, in December 2003, some three hundred thousand single-stock futures contracts traded on OneChicago, but 27.2 *million* securities options traded on its neighbor, the Chicago Board Options Exchange.[71] Because of this lackluster market performance, Chairman Newsome of the CFTC has recently indicated that he will ask Congress to give the CFTC sole authority to regulate single-stock futures. "Joint regulation 'is too burdensome, too cumbersome and quite unnecessary to protect the public good . . . . We are going to ask Congress specifically to take a look at the need for having a dual regulatory environment.'"[72] Congress should not jump so quickly.

Abandoning dual regulation at this stage is unwarranted and potentially dangerous. Chairman Newsome is no doubt correct in his statement that dual regulation is burdensome and cumbersome, but this paper argues that he goes too far to say that it is unnecessary. First, the fact that the market for single-stock futures has been poor to date under the dual regulatory system says nothing *a priori* as to whether the current system is fatally flawed.[73] This is a new market product, with complex regulation, being introduced at a unique time in the nation's economic history (*i.e.*, after significant stock market declines in recent years, numerous corporate scandals, a major terrorist attack, and ongoing foreign wars). It is not unreasonable to assume that it might take many months for the market to warm to single-stock futures. Second, the dual regulatory system has only recently been finalized with respect to important issues such as sharing information and oversight responsibilities,[74] setting margin requirements,[75] and establishing settlement procedures.[76] It may take awhile for market participants to become comfortable with this new product and with dual-regulation. For these reasons, the market should be given time to develop under the current regulatory regime and, if changes are needed, the CFTC and SEC should negotiate those changes. But dropping dual regulation

70. *E.g.* Alex Skorecki, *All Eyes are on EuroNext Exchanges*, Fin. Times (London, England) 27 (Dec. 8, 2003).

71. *See* Mark Skertic, *CBOT Starts New Era with Merc Link*, Chi. Trib. C1 (Jan. 3, 2004).

72. *See* Bloomberg News, *Regulator Weighs In on Stock Futures*, Chi. Trib. C3 (Mar. 18, 2004) (quoting Chairman James Newsome of the Commodity Futures Trading Commission).

73. For instance, it is entirely possible that the current regulatory regime is appropriate but that the limited interest in single-stock futures simply reflects improper marketing of these instruments to investors.

74. *See* SEC, *SEC and CFTC Sign Memorandum of Understanding Regarding Oversight of Security Futures Product Trading and Sharing of Security Futures Product Information*, Securities and Exchange Commission Release 2004-36 (Mar. 17, 2004) (available at http://www.sec.gov/news/press/2004-36.htm).

75. *See Customer Margin Rules Relating to Security Futures; Joint Final Rules*, 67 Fed. Reg. 53146 (Aug. 14, 2002), to be codified at 17 C.F.R. pts. 41, 242.

76. *See Cash Settlement and Regulatory Halt Requirements for Security Futures Products; Final Rule*, 67 Fed. Reg. 36739 (May 24, 2002), to be codified at 17 C.F.R. pts. 41, 240.

entirely so soon after its inauguration would be unwarranted and potentially dangerous.

Removing the SEC from the regulatory picture would be potentially dangerous because, as Chairman Levitt has stated, single-stock futures raise "profoundly serious" questions for securities regulation.[77] Insider trading provides just one example of this. As demonstrated herein, assuming that insider trading restrictions are important for the integrity of the securities markets, it is necessary for the SEC to enforce these rules with respect to single-stock futures. Furthermore, it is difficult to imagine how one might carve-out a limited enforcement role for the SEC leaving the CFTC as the sole primary regulator and rule-maker. The reason for this is that the SEC's enforcement functions are inseparable from its regulatory/rule-making functions. For example, the insider trading rules began in the courts,[78] but then migrated into the SEC rulebook.[79] In the end, it appears that what Chairman Newsome is really lamenting with respect to dual regulation of single-stock futures is its simple inevitability due to the fact that the United States has bifurcated securities and futures regulation between two competing federal agencies,[80] and that such a division of responsibilities cannot be squared with interests of regulatory simplicity or efficiency.

77. *See supra* n. 21 and accompanying text.

78. *See supra* nn. 50-54 and accompanying text.

79. For instance, the SEC has adopted Rule 10b5-1, 17 C.F.R. § 240.10b5-1 (2004), and Rule 10b5-2, 17 C.F.R. § 240.10b5-2 (2004), to proscribe certain insider trading activity and to resolve disputes among courts as to where insider trading liability should and should not lie. *See* SEC, *Insider Trading*, http://www.sec.gov/answers/insider.htm (last updated Apr. 19, 2001).

80. *See* Markham, *supra* n. 45 (for a discussion of comparative regulatory regimes and a discussion of interagency conflict between the CFTC and SEC).