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FINANCIAL MARKET REGULATION

Benefits and Risks of Merging SEC and CFTC

Statement of James L. Bothwell
Director, Financial Institutions and Markets Issues
General Government Division

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Mr. Chairman and Members of the Committee:

We are pleased to be here today to discuss the Markets and Trading Reorganization and Reform Act, H.R. 718. We strongly believe that there is a need for Congress to modernize the financial services regulatory system and commend your efforts toward this end. The intent of H.R. 718 is to improve the effectiveness and efficiency of financial services regulation by merging the Securities and Exchange Commission (SEC) and the Commodity Futures Trading Commission (CFTC), the two agencies responsible for regulating our domestic equity and futures markets. While we believe that this is a logical step for Congress to consider as part of its continuing modernization effort, Congress must ultimately decide whether the potential benefits of a merger outweigh the potential risks. In my testimony today, I will briefly discuss what we believe are the major benefits and risks that Congress needs to weigh in making this decision. I will also discuss certain specific issues related to H.R. 718 that we believe Congress should address if it proceeds to merge the SEC and CFTC.

Over the past several years, we have done substantial work in evaluating the regulation of both financial institutions and the securities and futures markets. This work clearly shows that the traditional distinctions and lines of demarcation that separate financial institutions, markets, and products are rapidly disappearing. Perhaps the best example of this phenomenon is the buying and selling of financial derivatives[1] by all types of financial institutions in all types of financial markets worldwide.

The current U.S. regulatory system, however, is a patchwork quilt of federal and state agencies that has not kept pace with the dramatic and rapid changes that are occurring in domestic and global financial markets. The principal components of our regulatory system date from the 1930s. Today, we have 10 different federal financial regulators, not including the Treasury Department or the various self-regulatory organizations, such as the stock and futures exchanges. Five of these 10 agencies (the Federal Reserve, Office of the Comptroller of the Currency, Federal Deposit Insurance Corporation, Office of Thrift Supervision, and National Credit Union Administration) regulate federally-insured depository institutions--i.e., banks, thrifts, and credit unions; two (SEC and CFTC) are primarily financial

[1]Derivatives are financial products whose value is based on, or derived from, the value of an underlying asset, reference rate, or index, called "the underlying." The underlying can include stocks, bonds, commodities, interest rates, foreign currency exchange rates, and indexes that reflect the collective value of underlying financial products.

market regulators; and three (the Office of Federal Housing Enterprise Oversight, the Federal Housing Finance Board, and the Farm Credit Administration) regulate those congressionally-chartered enterprises that help supply capital to the housing and agricultural sectors. Based on our past work, we have supported the merging of some of these regulators and functions to improve the effectiveness and efficiency of the financial regulatory system. H.R. 718 would further consolidate and streamline the existing system by bringing the nation's securities and futures markets under a single regulator.

POTENTIAL BENEFITS OF A MERGER

Merging the SEC and CFTC could yield a number of potential benefits. We believe the principal ones include

- -- reduced regulatory uncertainty, which would enhance market efficiency and innovation;
- -- increased regulatory effectiveness and efficiency; and
- -- greater ease in conducting international regulatory negotiations.

Unfortunately, none of these potential benefits is easy to quantify. And, while a merger may also yield some budgetary cost savings, they are unlikely to be of great consequence.

Reduced Regulatory Uncertainty

Merging the SEC and CFTC would eliminate the uncertainty that currently exists concerning their respective regulatory jurisdictions, as well as the related disputes that have periodically occurred between the two agencies. This uncertainty arises because the securities acts of 1933 and 1934 and the Commodity Exchange Act, as amended, define SEC's and CFTC's jurisdictions according to whether a particular financial product is either a security or a future. Making this distinction, however, is becoming increasingly difficult as more and more financial products are developed that combine features of both securities and futures. At the present time, both SEC and CFTC are asserting jurisdiction over some types of derivative products.[2]

Innovative market participants thus must either face the possibility that their new products may be subject to the jurisdiction of both agencies, or intentionally design new

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[2]Bankers Trust, for example, recently settled separate claims against it by both SEC and CFTC concerning its sales of certain financial derivatives to Gibson Greetings, Inc.

products to avoid such jurisdictional uncertainty.[3] Either alternative is likely to inhibit the forces of market innovation and efficiency.

Increased Regulatory Effectiveness and Efficiency

Historically, U.S. securities and futures markets have been regulated by different agencies, in part because they used to be separate markets serving different primary purposes.[4] Although their primary purposes still differ, the securities and futures markets and their participants have, without question, become increasingly linked over time. These linkages allow market disruptions to spread farther and more rapidly, and regulators need to have timely, consistent information on financial activities across these markets to better manage these disruptions.

A single U.S. regulatory agency for financial markets should be able to better monitor systemic risk across our increasingly linked markets, as well as to more effectively conduct cross-market surveillance and enforcement. Congress attempted to address this issue, in part, in the Market Reform Act of 1990 and the Futures Trading Practices Act of 1992, which provided SEC and CFTC authority to obtain information on material affiliates of the securities and commodities firms that they regulate. In implementing these provisions, however, both the SEC and CFTC could be receiving and reviewing the same information for companies that have both a securities and a futures affiliate. This would include all the largest broker-dealers and all the

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[3]Currently, the regulator for products that combine features of both securities and futures is identified by determining which component is likely to contribute most to the product's return. For example, a bond could have a return that is based partly on future changes in the price of a commodity such as gold. Deciding which agency will regulate such a product depends on a determination made before the product is traded as to whether the securities component--the bond--or the commodities component--the gold--will contribute most to the value of the product. This process can be complicated because it involves assumptions about future changes in gold prices. If the product is considered a future, the Commodity Exchange Act requires that it be traded on a regulated futures exchange unless CFTC specifically exempts it from this requirement. To avoid this, the product innovator may take extraordinary measures to ensure that the bond component of the product has more value than the gold component, and thus is considered a security subject to SEC's jurisdiction.

[4]The primary purpose of the securities markets has historically been to facilitate capital formation, while the primary purpose of the futures markets has historically been risk management.

largest futures commission merchants, as measured by capital. Merging the SEC and CFTC would eliminate any duplication associated with firms having to prepare the same information for these two different regulators. In addition, a single regulator's broader perspective may also better assure that market regulation is carried out in the public's interest.

Greater Ease of International Regulatory Negotiations

As our domestic financial markets and institutions become increasingly global in nature, there is a growing need to negotiate agreements with foreign regulators and to harmonize international regulatory standards. Currently, the United States has multiple financial regulators representing U.S. interests abroad, with both the SEC and CFTC engaged in negotiating international regulatory agreements and standards affecting our financial markets. Merging the SEC and CFTC could facilitate international negotiations by providing one regulator to negotiate with the international community about securities and futures.

Budgetary Savings Are Likely to Be Small

Merging the SEC and CFTC could produce some cost savings by reducing areas of program overlap and increasing administrative efficiency. Potential savings are likely to be limited, however, by the respective size of the agencies' current budgets and the fact that many of the functions performed by the separate agencies would still need to be performed by the new agency.

The bill would eliminate the need to fund five commissioners and their staffs. However, analyzing the extent of program overlap in SEC and CFTC's budgets is difficult because each agency's budget is organized differently. For fiscal year 1995, SEC's budget was $298 million for 3,039 staff, while CFTC's budget was $49 million for 545 staff. One of the largest areas of potential overlap is in central office functions. Obviously, a single agency would not need separate staff offices for handling congressional relations, public affairs, Freedom of Information Act requests, internal audit, and the like. Some overlap is also possible in the enforcement area, although a merger would not necessarily lead to a reduction in total enforcement staff because of the new agency's combined, or perhaps even expanded, mission. For fiscal year 1995, SEC funded 865 enforcement-related staff and CFTC funded 211.

Some savings are also possible because both agencies currently maintain separate offices located in the same cities. Both agencies are based in Washington, D.C., where about 60 percent of SEC's staff and about 40 percent of CFTC's staff are located. SEC has by far the more extensive field office organization, with five regional and six district offices. CFTC maintains separate regional offices in New York and Chicago, cities with eight exchanges between them, and has two smaller, more specialized regional offices in Kansas City and Los Angeles.

POTENTIAL RISKS OF A MERGER

In making its decision, Congress must ultimately weigh the potential benefits of a merger against its potential risks. The major risks include (1) a potential for over-regulation that may result in decreased market innovation and (2) a potential dominance of one market and regulatory perspective to the detriment of the other. There is also an operational risk arising from the fact that merging two agencies is at best a difficult task. Unfortunately, these potential risks, like the potential benefits, are also not easy to quantify.

Potential for Decreased Market Innovation

Some analysts believe that creating a single federal regulator for financial markets may hamper market innovation by eliminating the domestic regulatory competition that currently exists between the SEC and CFTC. Other analysts disagree, however, and argue that "competition in laxity" or "forum shopping" could have harmful effects on both markets and investors. It is impossible to measure the extent to which this interagency competition has benefited, or perhaps even harmed, the markets. Moreover, as financial markets and institutions become increasingly global in nature, the resulting competition among international regulators may reduce the impact of competition among domestic regulators.

Potential for Dominance of One Industry and Perspective

Merging the two agencies also creates the potential for dominance of one market and regulatory perspective over the other. If a merger brings together the SEC's and CFTC's staff in the same proportions as currently exist (roughly 6 to 1), the new agency would be composed predominantly of SEC staff. This could result in the dominance of the SEC's regulatory perspective over CFTC's and consequently a possible favoring of the securities industry's interests over the interests of the futures markets.

Operational Risk

Historical experience in both the public and private sectors indicates that successful mergers are not often easily accomplished. This is especially true when a merger involves two agencies, like the SEC and CFTC, that have quite different institutional cultures and histories. Furthermore, a successful merger may be particularly difficult to accomplish if the affected parties are reluctant to merge or opposed to it. The Chairman of the SEC has already testified that, while the SEC would be willing to accept the challenge, it does not view the merger as a priority. And the Chairman of CFTC has testified to her opposition to a merger with the SEC. Without a firm commitment on the part of both agencies, a successful merger between the SEC and CFTC may prove very difficult to accomplish.

SPECIFIC ISSUES RELATED TO H.R. 718

Should Congress ultimately decide to merge the SEC and CFTC, we believe it should address several issues related to H.R. 718. Specifically, we believe Congress should consider

-- establishing a process for updating and harmonizing our existing securities and commodities laws;

-- clarifying the mission of the proposed Federal Financial Markets Coordinating Council;

-- reassessing the executive branch's authority over the new regulatory agency to assure its independence; and finally,

-- specifying how the new agency is to be funded.

Harmonizing Securities and Commodities Laws

As we have already discussed, H.R. 718 could reduce some of the regulatory uncertainty that currently exists in the markets by merging the SEC and CFTC. However, uncertainty stemming from inconsistencies and anachronisms in the underlying securities and commodities laws would still exist unless progress is made to update and harmonize these laws to reflect market realities. Although a merger between SEC and CFTC need not be made contingent upon such a harmonization, Congress could use H.R. 718 to specify a vehicle for accomplishing this purpose.

Role and Composition of Coordinating Council

H.R. 718 creates an interagency Federal Financial Markets Coordinating Council comprised of the Treasury Department and six federal financial regulatory agencies. While it is important to have a mechanism for different financial regulators to discuss and coordinate their policies, it is unclear to us whether this Council is intended to supplement or supplant the President's Working Group on Financial Markets. The Working Group, comprised of the Treasury Department, the Federal Reserve, the SEC, and CFTC, was created by presidential order after the 1987 stock market crash in order to address cross-market concerns and determine what coordinated regulatory actions would help strengthen the nation's financial markets. If it is the present bill's intent to supplement the Working Group, the mission of this new council could be duplicative of the activities of the Working Group. However, if it is Congress's intent to replace the Working Group with the Council, clarification of the

Council's mission would be required. In addition, the composition of the Council should be related to its mission. For example, if the Council's purpose is to supplant the Working Group, it may not be necessary to include each of the five regulators of federally insured depository institutions as permanent members.

Executive Branch Authority

SEC has interpreted certain provisions of H.R. 718 as increasing the executive branch's authority over the merged agency, and is concerned that such provisions could jeopardize the independence of a merged agency. These provisions include (1) the President's authority to modify or revoke SEC and CFTC rules and (2) the authority of the Office of Management and Budget and the Office of Personnel Management over the new agency in matters dealing with personnel and administration. Both the SEC and CFTC have long histories as independent agencies. This independence needs to be preserved, and we believe H.R. 718 should not be ambiguous in this regard.

Agency Funding

Because the sources of funding for each agency are different, Congress may wish to consider how to fund the merged agency. Currently, SEC's budget consists of both earmarked fees and general funds. Specifically, about $223 million of SEC's $298 million 1995 budget (75 percent) derives from fees it collects, and about $75 million (25 percent) from Treasury's general fund. About $400 million in additional SEC fees is projected to go into the Treasury's general fund. In contrast, CFTC's $49 million budget comes entirely from the Treasury's general fund, and the agency typically collects less than $2 million each year in fees.

In conclusion, Mr. Chairman, I would like to state that you and your Committee are to be commended for addressing the modernizing of the financial services regulatory framework. The issues involved in reforming market regulation are complex and involve difficult policy judgments. Yet such issues need to be addressed to enhance the ability of U.S. financial markets to compete globally and better position themselves to meet the challenges of the future.

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Mr. Chairman, this concludes my prepared statement. We will be pleased to answer any questions you or Members of the Committee may have.

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