

International Securities Exchange
Proposal for

Regulatory Reform for the U.S. Financial Markets

March 2009



INTERNATIONAL SECURITIES EXCHANGE.

Introduction

The International Securities Exchange (ISE) operates the world's largest equity options exchange and offers options trading on over 2,000 underlying equity, ETF, index and FX products. ISE provides investors with an efficient, transparent marketplace for price and liquidity discovery on centrally cleared options products. The exchange is regulated by the Securities and Exchange Commission (SEC) and is a member-owner of The Options Clearing Corporation (OCC).

About ISE

Expertise and leadership on issues related to regulatory structure in the U.S. securities markets.

- First newly registered securities exchange in 27 years
- First registered securities exchange to demutualize
- First registered securities exchange to go public
- First U.S. registered securities exchange to be owned by a foreign entity

In 2000, ISE became the first newly registered securities exchange approved by the SEC since 1973. On May 26, 2000, ISE launched trading as the first all-electronic options exchange in the U.S. and subsequently transformed the options industry by creating efficient markets through innovative market structure and technology. ISE quickly grew to become the leading options exchange for single stock options and maintains that position today.

Two years after its launch, ISE became the first securities exchange to demutualize and split trading rights from ownership rights. ISE also led the industry in corporate governance by establishing a Board that consisted of a majority of non-industry directors. On March 9, 2005, ISE successfully completed an Initial Public Offering.

ISE became a wholly owned subsidiary of Eurex, a leading global derivatives exchange, on December 19, 2007. Eurex itself is jointly owned by Deutsche Börse AG (Ticker: DB1) and SIX Swiss Exchange AG. Together, Eurex and ISE are the global market leader in individual equity and equity index derivatives.

Regulatory Reform

The U.S. system of bifurcated regulation by financial instrument is inefficient and ineffective. The division of regulatory responsibility between the SEC and CFTC has resulted in regulatory gaps, jurisdictional stalemates and inconsistent regulation of financial products and industry participants. Internationally, all major financial market centers have taken a comprehensive approach to regulating financial markets.

Oversight Structure Should Focus on Function

Assuring that all aspects of the financial markets are regulated, and that responsibilities are grouped together rationally across all financial services and products, is more important than determining which agencies are tasked with various responsibilities.

Responsibilities should be grouped together so that regulation is comprehensive. There are three aspects of financial regulation that should be grouped together:

- **Financial Systemic Risk:** financial and capital matters involving commercial and investment banks, as well as futures commission merchants, investment companies and hedge funds.
- **Disclosure:** disclosure/risk analysis for investors, which would cover corporate issuers, investment companies and product-specific risk.
- **Financial Industry Operations:** the operation of financial markets, trading platforms and financial service providers, including but not limited to the services traditionally provided by broker-dealers, investment advisors, hedge funds and futures commission merchants.

Our Focus

As a registered national securities exchange, ISE's focus is on the Financial Industry Operations aspect of regulation.



Risk-Based Regulation Should be Adopted

Risk-based regulation seeks to proactively identify practical methods to address risk, whereas rules-based regulation is reactionary to compliance failures.

Risk-based regulation focuses compliance efforts of both the regulators and those they regulate on areas that pose the most risk to the system. The SEC applies a rules-based approach, while the CFTC employs a risk-focused approach to regulation based on principles.

- **Rules-based:** Congress adopts very specific rules to govern the operation of the market, and the regulatory agency implements those rules with little discretion. There is a focus on prosecuting those that fail to comply with a detailed rule.
- **Risk-based:** Congress identifies areas of highest risk, adopts specific regulatory objectives and grants the regulated entities flexibility in establishing rules to comply with those objectives. There is a results-oriented focus on compliance.

Securities Regulation under the 1934 Act is Outdated and Ineffective

The rules-based approach of regulators under the 1934 Act emphasizes form over substance, leading to inefficient use of regulatory resources.

The Securities Exchange Act of 1934 (“the 1934 Act”): Under the 1934 Act, the SEC governs broker-dealers and securities exchanges with a rules-based regulatory structure that is outdated.

- The 1934 Act envisions a world of mutualized member-owned exchanges where people physically gather to trade securities.
- In applying the 1934 Act to the realities of today’s financial markets, the SEC has developed its own regulatory policies through the rule-review process for registered exchanges, exemptive orders and no-action letters.¹
- In most cases, this development of regulatory policy is opaque, without proper public input and without a statutory foundation, and has resulted in policies that are not focused on a rational outcome and that are unnecessarily restrictive on market participants.²
- The mechanical application of the 1934 Act results in wasted government and industry resources without any regulatory benefits.³

Regulation under the Commodity Exchange Act is More Effective

This risk-based regulation has closer oversight, more transparency, and more flexibility to achieve regulatory objectives.

The Commodities Futures Modernization Act of 2000: Under the Commodity Exchange Act, as modified by the Commodities Futures Modernization Act of 2000, the CFTC applies a risk-based regulatory approach, with Congressional oversight through the reauthorization process.

- The CFTC concentrates its activities in areas with the most risk.
- Regulated firms can follow CFTC “safe harbors” (i.e., guidelines that if followed, assure compliance with the principles) or propose their own methods for complying with regulatory objectives.
- Risk-based regulation requires greater collaboration between the regulators and the entities being regulated, and a higher level of expertise on the part of regulators to identify areas that require the most attention.

Moving to Risk-Based Regulation

A successful transition to risk-based regulation will require a complete change in approach and mindset of those that apply the securities laws.

Apply regulatory standards across industry participants fairly. Regulators have to look at the function being performed by a market participant regardless of any designation.

- All trading systems need to be subject to the same set of risk-based objectives and to the same level of regulatory scrutiny.⁴

Focus on regulatory priorities. Federal agency-level regulators must focus on ensuring that there is broad and effective oversight of all markets and products.

Focus on compliance rather than enforcement. Risk-based regulation applies a prudential approach where the focus is on assuring compliance rather than bringing enforcement actions.

Regulation of Financial Industry Operations

Step 1: Congress creates a single regulator for the U.S. financial markets (U.S. Financial Markets Commission or “FMC”). The FMC would encompass current SEC and CFTC Financial Industry Operations regulatory and policing functions.

Proposal for New Regulatory Oversight Structure

Strengthening Congressional oversight, with a focus on educating regulators, is critical to the establishment of effective, risk-based regulation for Financial Industry Operations.

- The FMC will have expanded jurisdiction over all participants in the financial markets (e.g., hedge funds and rating agencies).
- The FMC may be a stand-alone agency or part of a bigger agency.

Step 2: Congress adopts new, risk-based regulation that replaces the 1934 Act and the Commodity Exchange Act.

This new statute would adopt a risk-based regulatory structure that establishes specific regulatory objectives.⁵ Based on these objectives, regulated entities develop rules to govern their own operations.

- The FMC would be required to focus its attention on the areas of highest risk.
- The FMC would be required to focus on cost-benefit analysis, not only with each regulatory effort, but among regulatory efforts.

Step 3: Congress creates a transitional authority (“TA”). The TA will oversee the transition to a risk-based regulatory structure and the transition of functions from the SEC and CFTC to the FMC.

- The TA will approve all regulatory objectives and policies adopted by the FMC to implement the new statute.
- The TA will have responsibility for overseeing initial educational efforts of the regulators.
- The TA will have an 18-month authorization, ending with a report to Congress on the transition.

Step 4: FMC adopts its own risk-based objectives. The FMC will adopt more specific objectives to implement the statute, as well as safe harbors for implementing the objectives (i.e., guidelines that if followed, would assure compliance), making clear they are non-exclusive safe-harbors.

Self-regulatory organizations (“SROs”). Under the 1934 Act, all registered exchanges, clearing agencies and national securities associations are SROs with the responsibility to enforce the federal securities laws as well as their organization’s own rules.

- The SROs are funded by the industry, not taxpayers.
- SROs are closer to market activity and generally have greater expertise with respect to the operation of trading systems and market participants.

The Role of Self-Regulatory Organizations

An enhanced self-regulatory structure is needed to effectively regulate the financial markets and its participants.

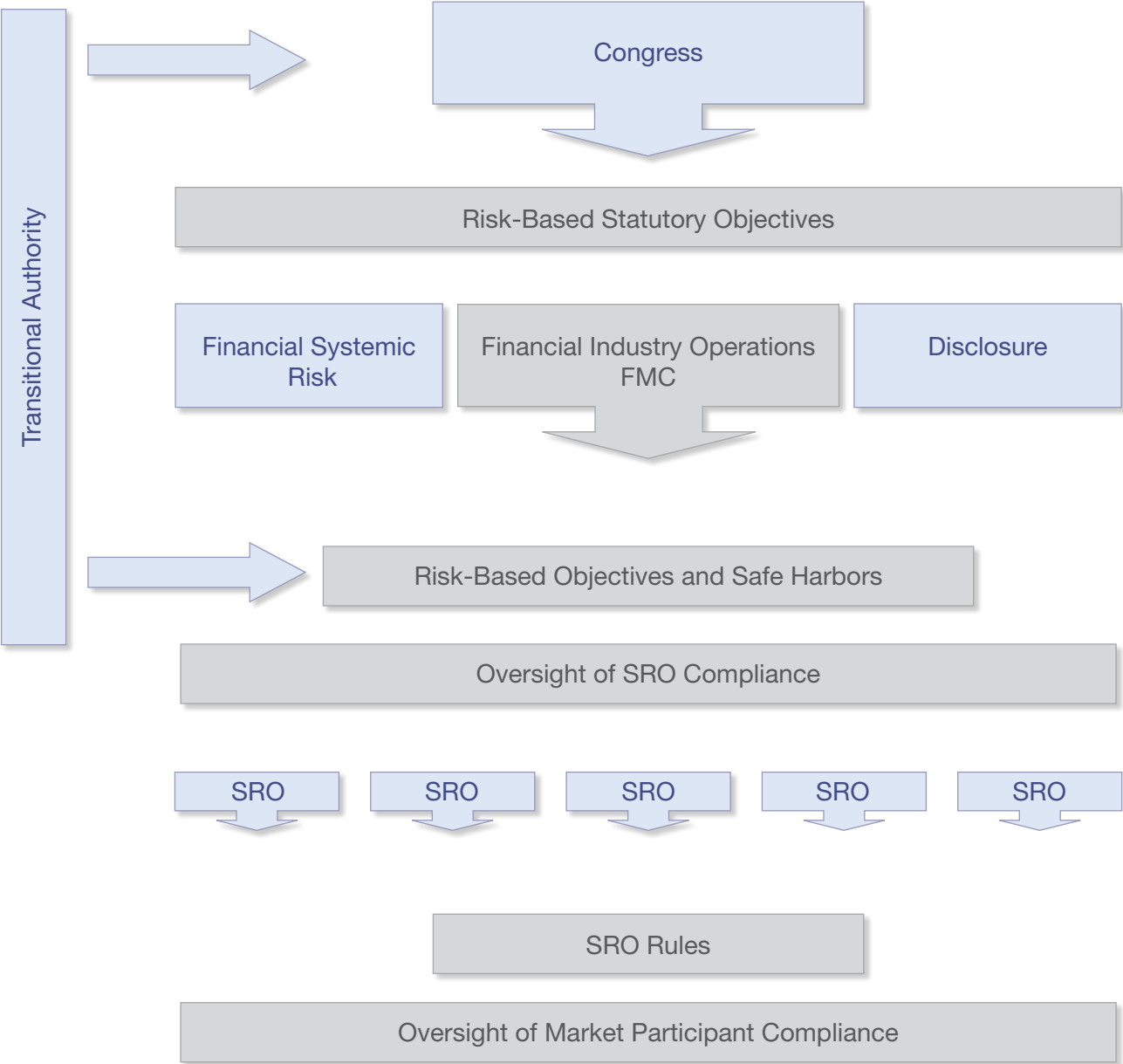
FMC Oversight of SROs. The FMC will adopt risk-based objectives specific to the operation of financial markets, trading platforms and financial service providers.

- Under the scrutiny of the TA, the FMC will review and approve the SRO’s adoption of rules, processes and procedures for implementing the objectives.
- The FMC will then implement a review and compliance program for oversight of the SROs, which will adhere to the risk-based regulatory structure.
- SROs will conduct investigations and enforcement actions under FMC direction and oversight, so that duplicative regulatory efforts are avoided and FMC staffing requirements are minimized.
- Perceived weakness in SRO structure will be addressed through enhanced FMC oversight that is focused on the SROs’ adherence to the established risk-based objectives.

Enhanced SRO Oversight of Market Participants. The SROs will have the responsibility to monitor, investigate and enforce the statutory and FMC objectives, as well as compliance with SRO rules.

- The scope of each SRO function will be defined on the FMC level so that regulatory gaps and inefficiencies are eliminated.⁶
- The statutory SRO designation will be uncoupled from the operation of a trading system, so that all trading systems are subject to the same regulatory objectives and procedures.
- Trading system functionality will be reviewed and approved by SROs according to FMC-approved objectives and guidelines.

Regulation of Financial Industry Operations



Discussion and Examples

¹ The 1934 Act does not envision a broker-dealer operating an exchange-like execution system. However, in 1997, the SEC adopted a regulation based on the statutory definition of “exchange” (Regulation ATS) governing broker-dealer exchange-like execution systems in a manner that has resulted in different treatment of exchange-operated execution systems and broker-dealer operated execution systems. (See also note 4 below.)

² For example, as exchanges have demutualized in a public company world the SEC has imposed 20% maximum ownership limits unless the owner itself submits to various aspects of exchange regulation. There is no statutory basis for this, but exchanges agreed to the condition to gain approval of their reorganizations. There has been no review of such SEC process. There are many other examples of limitations the SEC has imposed on exchange trading rules without rulemaking and without statutory basis, such as a 40% limit on participation rights for facilitations and maximum quotation spreads of \$5 for options. In this way, the SEC staff defines industry standards by approving specific exchange rule filings, rather than by publishing notice that it has made a broadly applicable policy determination that impacts the industry as a whole. This is a non-transparent approach, and the result is that exchanges only learn about modifications to established standards when a rule filing is approved that changes or eliminates the standard.

³ For example, exchanges that list the securities of corporate issuers (e.g., the New York Stock Exchange) have SEC-approved standards and rules regarding what securities are qualified to be traded on the exchange. These listing exchanges have extensive rules regarding, among other things, a listed-company’s corporate governance and public disclosure requirements. Issuers choose the market on which they list, and they pay listing fees to these markets. Under the 1934 Act, once the securities of a corporate issuer are listed on an exchange, all other exchanges are permitted to trade the securities on an unlisted basis (i.e., the issuer has not affirmatively chosen to have its securities traded on the exchange). However, the SEC has taken the position that exchanges trading securities on an unlisted basis must adopt listing standards for the securities, and must go through the exercise of qualifying each security and monitoring that the security continues to meet the listing standards. The adoption and modification of these listing standards on multiple exchanges trading corporate securities is duplicative and unnecessary from a regulatory perspective. Yet substantial effort is spent by the exchanges and the SEC staff to maintain this mechanical approach to regulation under the 1934 Act. Similarly, the SEC has required exchanges to file for approval of certain products, even if such products have already been substantively evaluated and approved by the SEC.

Discussion and Examples

⁴ Several equity trading systems operated by broker-dealers execute more volume than some registered exchanges, yet their trading system rules are not subject to the SEC's review and approval process. There is no regulatory reason why, in the name of customer protection, an exchange-operated trading system needs such regulatory scrutiny while the other does not. In this respect, the SEC staff's focus on micro order execution processes in automated exchange trading systems is an example of misplaced focus with little regulatory benefit.

⁵ For example, three possible areas that may pose substantial risk to the securities markets are counterparty risk, lack of liquidity and operational failures. Congress would set forth the objective of mitigating these risks, and SROs responsible for trading system oversight would establish rules that address these risks.

⁶ Currently under the 1934 Act, all SROs are presumed to be charged with responsibility for all areas of regulation. However, Section 17 of the 1934 Act allows SROs to enter into agreements, approved by the SEC, that provide relief for certain of their responsibilities. Accordingly, over the years, a network of agreements has been adopted that limits some SROs' responsibilities and consolidates certain regulatory functions in a single SRO. However, this approach leaves large regulatory gaps, creates regulatory friction and inflates the cost of regulation. New regulation that defines subcategories of SRO responsibilities and allows SROs to designate which types of regulation they are undertaking would clarify responsibilities and highlight regulatory gaps.