

STARTING THE CONVERSATION ON THE FUTURE OF REGULATION



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As legislators and policymakers in Washington examine the flaws in regulatory oversight that contributed to the financial crisis, discussions have initially focused on the proper identification and management of systemic risk. Clearly, devising a method to manage systemic risk is a central and critical component to any regulatory reform proposal. However, it is not the only component. Any discussion of systemic risk would be incomplete without a review of the proper oversight of financial markets, products, and their users. Now is the right time to examine how to improve the regulatory framework that we as an exchange, our member firms, and other market participants operate under. In this way, the financial crisis should serve as a powerful impetus to make the U.S. financial markets stronger and to enhance those aspects of the markets that have served the economy well during the downturn.

As one of seven U.S. securities exchange operators, ISE is in a unique position to offer recommendations to remedy shortcomings in the current system of financial market regulation and to strengthen the

regulatory framework to accommodate an industry in perpetual motion. To that end, we published a proposal for regulatory reform in late March that details a new oversight structure for trading venues, financial products, and market participants. The goals of this proposal are straightforward: remove regulatory gaps, eliminate inconsistencies, and alleviate jurisdictional stalemates. In order to accomplish these objectives, we propose a new oversight structure that is comprehensive, consistent, and risk-based. In our view, these three elements represent the fundamental tenets that would support a strong regulatory foundation for the U.S. marketplace.

Each of these three components would address a specific shortcoming of the outdated, bifurcated structure for market oversight that exists today. First, a comprehensive regulatory framework goes hand-in-hand with the establishment of a systemic risk regulator. Today, there are markets of systemic importance that operate with no regulatory oversight. The bilateral OTC market for credit default swaps has received

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the most scrutiny from Washington as a result of the exposures revealed by the financial crisis. However, other large markets, such as the FX cash market, also operate outside of the regulatory framework. Despite their proliferation in recent years, the many online, retail-oriented FX trading venues offer no protection for customers. FX also suffers from inconsistent regulation in the related derivatives markets: FX futures are regulated by the CFTC while FX options are regulated by the SEC. Any comprehensive regulatory structure must provide a clear oversight mandate for all markets of systemic importance and offer consistent regulation of related financial products.

In our proposal, ISE calls for the establishment of a Financial Markets Commission (FMC) that would combine the current market oversight functions of the SEC and CFTC. Congress would empower the FMC to establish regulatory objectives that promote comprehensive and consistent standards for oversight of markets and products. Bringing the SEC and CFTC together would also eliminate jurisdictional stalemates that have occurred between these two agencies. For example, an eighteen-month stalemate occurred during which the SEC and CFTC struggled to determine which regulator had the authority to oversee options trading on the gold ETF (ticker: GLD) – a security product that was based on a physical commodity. While this stalemate was in effect, options on GLD could not trade on any of the options exchanges. Instead, they traded in the upstairs market and did not benefit from the transparency and central counterparty clearing offered

by the exchanges. When regulators do not approve an exchange's application to list a new product, this is not an indication that the product will not trade. Regulators should keep in mind that by not approving a product, they are confining it to the OTC market and could be adding to overall systemic risk.

Most importantly, ISE's proposal advocates that a new regulatory structure should be risk-based. Regulatory resources – time, personnel, and budget – are finite. Regulators must have the requisite flexibility to evaluate which areas pose the greatest systemic risk and to focus their efforts on these areas. An OTC product with total notional outstanding of \$10 million should not be regulated in the same way as an OTC product with notional outstanding of \$10 billion. It is essential that regulators be able to focus on the whole forest and not be required to inspect every single tree. In order to accomplish this type of structure, Congress will need to pass legislation that supports this regulatory construct.

Over the next several months, legislators and policymakers will examine the financial industry and its regulators like never before. During this time, we must not lose sight of the strengths proven by the financial crisis: the benefits of central counterparty clearing, the critical role of exchanges, and the importance of sound risk management. We must use this unique opportunity to modernize the regulatory structure to make these areas of the markets even stronger. We hope ISE's proposal for regulatory reform will be an important first step in this essential dialogue.

IT'S TIME FOR REGULATORY REFORM



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