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**Regulation and Supervision in the Context of a Global
Financial Environment**

*9. Speech by Mr. Robert Wilmouth
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of United States of America*

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Speech of Robert K. Wilmouth
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“Regulation and Supervision in the Context of a Global Financial Environment”

I would like to thank my gracious hosts from Istanbul-The Capital Markets board and the Istanbul Stock Exchange, and IOSCO for inviting me to participate in this panel discussion today. It is wonderful to be here today. My guidebooks referred to Istanbul as an unforgettable city and from what I have seen and plan to see, the guidebooks are right.

I have had the opportunity to witness firsthand the remarkable evolution of the financial markets from two unique perspectives. First, in my role as chairman of IOSCO’s SRO Consultative Committee, I have seen new exchanges emerge from all corners of the world and have championed the role of self-regulation within the regulatory structure of these new markets.

And second, I have served as the president of National Futures Association, the nationwide self-regulatory organization for the United States futures industry, since its inception in 1982.

For those of you who may not be familiar with NFA, I’d like to take a minute to give you some background on the organization. In the 1970s there was growing concern about investment fraud on the fringes of the U.S. futures industry. Commodity firms were failing and customer confidence in the markets was decreasing.

The U.S. Congress responded in 1974 by establishing the Commodity Futures Trading Commission, a federal regulatory agency with jurisdiction over futures trading. The same

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legislation authorized the creation of “registered futures association,” which gave the futures industry the opportunity to create a nationwide self-regulatory organization to work in conjunction with CFTC oversight.

When NFA opened its doors in 1982, we immediately began developing programs and practices that would be applied to all futures market professionals. We instituted a thorough and rigorous registration screening process for all firms and individuals wishing to do business with the public on any U.S. futures exchange. We adopted stringent rules covering a wide variety of areas such as advertising, risk disclosure, capital requirements and proficiency testing. We audit and monitor our members to ensure compliance with our rules and regulations. We also developed an arbitration program to help investors resolve futures-related disputes.

Two decades after NFA’s launch, trading volume of the futures exchanges has increased in excess of 400 percent. During the same period, customer complaints dropped 72 percent and losses due to firm insolvencies have decreased more than 90 percent. I think NFA’s story is a textbook example of the success that can be achieved when an independent effective and efficient regulatory body focuses solely on its mission to ensure market integrity and investor protection.

As I said earlier, I have had the opportunity to view firsthand the dramatic evolution of the derivatives markets. Twenty years ago, when NFA began operations, all futures trading was conducted on the floors (or trading pits) of the exchanges. Orders were received by telephone and delivered by hand to the traders in the pits where all contracts were bought and sold by open-outcry. There was no computer-based trading. There were very few futures markets outside of the United States. And the total number of futures contracts traded in 1983 was approximately 140 million.

Two decades later, I’m one member of an international panel composed of representatives from the United States, Hong Kong, Belgium and Sweden. Futures trading is conducted

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around the world at any hour of the day on computers. There are futures exchanges located all around the globe. And the number of futures contracts traded in 2001 totaled more than 2 billion.

I think you'll agree--that is quite a dramatic evolution. And it is mirrored in the dramatic growth of the securities industry.

We truly have entered an exciting era of technology-based global financial markets. We have also entered a challenging era for regulation. That's what I would like to discuss with you today: what regulators must do on an international scale in order to continue to ensure market integrity and provide customer protection in a marketplace that is increasingly technology-driven and decreasingly defined by national borders.

Demutualization

When I addressed the IOSCO conference last year in Stockholm, I noted that in the year 2000, eleven exchanges from around the world converted to a for-profit status, including the Chicago Mercantile Exchange, the London Stock Exchange, the Hong Kong Stock Exchange and the Sydney Futures Exchange. In 2001, due to an unsteady world economy and other more frightening world events, the move to demutualize has slowed somewhat. However, the reasons why exchanges are demutualizing and the benefits derived from demutualization have not diminished.

By demutualizing, exchanges will have a way to raise large pools of capital to finance modernization plans and new technology to compete in today's global marketplace. This can be done eventually through share offerings to non-members.

Demutualization will also change the way the exchange is governed. Under a demutualized structure, the exchange will be owned by shareholders who will have a stake in the exchange being a profit-generating entity and will be run by a management team, which is driven to improve the exchange's bottom line.

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Demutualization also provides exchange members the chance to realize the market value of their equity in the exchange while retaining their trading rights. Under the current system, the value of an exchange membership can only be realized by selling the seat, which results in the member's losing his trading privileges. By separating these two components, members will no longer have to give up their trading rights to realize the market value of their equity. If all goes as planned, members will be able to realize the equity value in a secondary market for freely tradable equity shares.

New exchanges, alliances and trading platforms

Another trend in the evolution of the global marketplace is the increased competitive environment caused by the introduction of new exchanges, alliances formed by existing exchanges, and alternative trading platforms. The impending introduction of security futures products in the United States has also prompted the formation of several new exchanges. In the past eighteen months alone, five new futures exchanges have been approved as designated contract markets by the CFTC – Brokertec Futures Exchange, Island Futures Exchange, Merchants Exchange, Nasdaq Liffe Futures Exchange, and Onexchange Board of Trade. Furthermore, two additional exchanges are pending approval with the CFTC. Compare that with the period 1986-1997 when the CFTC designated only two new exchanges, neither of which ever began trading, and you'll have some idea of the magnitude of the changes occurring in the financial markets. All of these new electronic exchanges will bring increased competition to the marketplace.

Technology has also given rise to the development of new forms of competition, including electronic communications networks, or ECNs. These new electronic systems are for the most part owned by well-capitalized, for-profit entities that seek to link geographically dispersed buyers and sellers of specific products. They are nimble competitors, unencumbered by the membership structures characterized by older, existing exchanges.

As you can see, there are more and more trading vehicles providing an ever increasing variety of products for both retail and institutional investors in the financial markets these days. The number and variety of trading choices available to the investing public will continue to soar.

Outsourcing of Major Functions

In light of today's competitive and advanced technical environment, and the focus on the bottom line resulting from demutualization, exchanges will be driven to re-evaluate their business model and re-engineer their business processes. More and more traditional exchanges will be forced to compete with emerging electronic exchanges and marketplaces around the globe.

Exchanges have three primary functions: trading, clearing and regulation. Traditionally, exchanges have developed and maintained all of these functions internally. However, the costs to develop and maintain these functions internally can be significant. Both traditional and new electronic exchanges are looking for effective and efficient ways to do business in a highly competitive environment. Most, if not all, new electronic exchanges in the United States are entering into outsourcing arrangements for their trading, clearing and regulatory services. That means that an exchange may outsource these functions to three different service providers in different parts of the country—or even different parts of the world, creating a truly borderless marketplace.

Outsourcing of Regulatory Functions

I would now like to examine how this new global competitive environment will impact the quality of markets and market integrity or better said – Will cost pressures diminish market integrity and decrease efforts to ensure investor protection?

A marketplace has two general regulatory objectives: ensure market integrity and protect customers using the market. Those regulatory objectives do not change when an exchange de-mutualizes or faces stronger competition. The quality and integrity of a market is one of its key assets and a distinguishing feature that they must vigorously protect.

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In order to satisfy the regulatory objectives just mentioned a market must establish rules to govern the conduct of the users of its market, monitor compliance with those rules and take strong disciplinary action when an entity breaks those rules. As you would expect, a market will always want to write and apply its own rules. However, new electronic markets feel that the monitoring of those rules can be outsourced to a regulatory organization that has a track record of providing effective and efficient regulatory services. These regulatory services can include registration and background checks, market surveillance, financial surveillance, investigations and dispute resolution.

NFA has seen this new outsourcing model emerge for regulatory services in the last few years in the United States. New electronic exchanges are focusing on their cost structures. They recognize that the monitoring function can be done effectively and at a lower cost with a third party provider of these services rather than performing this function with its own internal staff and surveillance systems. This third party ideally should be an independent entity with no market affiliations, should have a reputation, and should have the ability to tailor its services to meet the specific needs of each exchange.

I can tell you from my own experience at NFA that outsourcing is becoming a popular regulatory model. NFA has signed contracts with four new exchanges to perform regulatory services on their behalf and are in talks with several others. And these new exchanges are not confined to the United States.

A recently demutualized exchange outside of the United States contacted NFA to discuss the possibility of outsourcing their regulatory responsibilities to us. Although there are some legal, linguistic and cultural differences, the underlying products and trading systems are similar to those we currently regulate. Of course, we would need to educate ourselves on the politics, regulatory regime, legal differences, and tax and incorporation issues of this exchange's native country. But it's further proof that global boundaries are disappearing.

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But no matter how an exchange meets its regulatory obligations, either through its own infrastructure or by outsourcing to a third party provider, the twin principles of market integrity and customer protection must be upheld. That means that the statutory regulator must ensure that the entity performing these regulatory services on behalf of an exchange meet high standards of business conduct and meet the requirements established by the statutory regulator.

Global Regulatory Issues

I would now like to focus on customer protection issues and the continuing need to increase information sharing among regulators around the world.

Investors are now confronted with a multitude of trading opportunities from around the globe. They can obtain trading recommendations, open an account, place orders on an electronic market, receive confirmation statements and transfer funds—all from their home computers.

In the very near future, if its not happening already, an investor may be able to sit down at his computer, access any market in the world and trade all types of products (securities, futures, options, OTC products). Some of these products will be traded on regulated markets, some will be subject to regulation in a jurisdiction separate from the investor's local jurisdiction, and some will not be regulated at all.

How must we as regulators adapt to this new environment? How do we protect market integrity and provide customer protection to customers who are trading on multiple marketplaces around the world?

First and foremost, regulatory organizations must make a stronger commitment to investor education. Education is the first line of defense against fraud. Investors must understand the product they intend to trade, know that the marketplace has a strong reputation for market integrity, and have knowledge of any disciplinary history of the intermediaries and brokers with whom they are doing business. No investor, big or small, can avoid doing

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rigorous due diligence, and we as regulators must do everything we can to help investors get this information quickly and easily.

At National Futures Association, we have always had a strong investor education program. We have published several brochures on investing in general and on the specific opportunities and risks associated with trading derivatives. In anticipation of the introduction of trading of security futures products, we have recently published an investors guide to these new products. Recognizing the need to make this information easily accessible to investors around the globe, NFA also provides the same information free of charge on its web-site.

We have also found other ways to provide information to investors. In 1996, we introduced the Background Affiliation Status Information Center (BASIC). BASIC, which can be accessed through NFA's web site. BASIC contains current and historical registration information concerning all current and former CFTC registrants. It also provides information concerning disciplinary actions taken by NFA, the CFTC and all the U.S. futures exchanges. Investors and regulatory bodies around the world use this system. The success of BASIC is reflected in the fact that the system receives more than 38,000 inquiries each month.

We're very proud of BASIC. That's why we were excited when the CFTC approached us to help them develop a system that will provide international regulators with the information they need regarding U.S. registrants that conduct business in other jurisdictions.

This new system, called the International Regulators Alert System, will incorporate elements of the BASIC system and NFA's new Online Registration System. It will be available this summer. If an U.S. firm intends to do business in another jurisdiction, a regulator can request via e-mail all regulatory information relevant to that firm. That regulatory information will include registration status and history and all disciplinary

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actions taken against a firm by a U.S. futures exchange, the CFTC and NFA. Once the initial request is made, the system will automatically send the regulator quarterly notices. More urgent information regarding the firm (e.g., withdrawal from membership, disciplinary actions, etc.) will be sent to the regulator immediately. If anyone in today's audience is interested in getting more information about this system, please give me your card today or send me an email.

Given language and cultural differences, sharing information is not as easy as it may appear to be. Nevertheless, we must aggressively look for innovative solutions to information sharing if we are to continue to provide effective customer protection.

The International Regulators Alert System is the sort of pro-active international regulatory collaboration that we all need to pursue. Technological advances have transformed our markets by making it possible for investors to conduct almost any kind of financial transaction on any market around the world. We, as regulators, must use the same technological advances to devise creative solutions to preserve the integrity of a truly international marketplace.