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Washington Goes to Wall Street

July 2009
By Tam Harbert

As traders, investors, bankers and government regulators stand in the midst of the fallout from what one money manager calls a "financial Chernobyl," everyone is scratching their heads, trying to figure out exactly how it all happened.

That's a process that is likely to take many years. There are plenty of factors and plenty of blame to go around, according to a recent report by Paul Zubulake, a senior analyst at Aite Group LLC, an independent research and advisory firm for the financial services industry. "The crisis has truly been a team effort," he says. The U.S. Federal Reserve, regulatory agencies, credit agencies, politicians, and people and institutions that brokered bad deals all played roles.

Meanwhile, the government needs to start rebuilding and reforming the system today, without the benefit of a perspective that will come from years of research into how things went wrong. While organizations such as the President's Working Group on Financial Markets try to coordinate comprehensive reform, what is going on now seems to be a regulatory scatter-shot approach, with the end result unclear.

"I'm worried that there's going to be a bunch of quick fixes, when what we really need is three to four years of serious study and a complete remaking of the regulatory code around all these asset classes," says Harold Bradley, chief investment officer for the Ewing Marion Kauffman Foundation, which studies and promotes entrepreneurship. He oversees the foundation's multiasset-class, \$1.7 billion portfolio.

The current system is outdated in several ways. First, the original post-Depression laws have not kept up with the evolution of new markets. In the 1930s and '40s, stocks and bonds were the only assets. "Now you have all these esoteric products, all these derivatives and options and futures," says Jean McLenigan, owner of Compliance Partners LLC, a consulting firm serving broker-dealers and investments advisers. "The laws have never been adequately updated to address that."

Second, those laws have been weakened during the past few years, creating regulatory gaps. The Financial Modernization Act of 1999, also known as the Gramm-Leach-Bliley Act, repealed provisions of the Glass-Steagall Act of 1933. That act had restricted the ability of bank-holding companies to affiliate with securities firms and insurance companies. As a result of GLBA, however, "U.S. financial conglomerates could operate in virtually all areas of financial services, but the regulatory structure remained largely institutional," says Zubulake's report. Oversight of these conglomerates was split among the Securities and Exchange Commission, bank regulators and state insurance commissioners, with no single agency having authority over the entire financial company. Then in 2000,...

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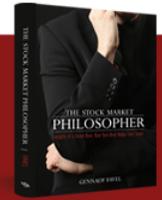


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the Commodity Futures Modernization Act effectively deregulated certain over-the-counter (OTC) derivatives by specifically stating that they were outside the jurisdiction of the Commodity Futures Trading Commission.

What's more, technology has revolutionized the way assets are traded—at least in stocks and many commodities. The use of electronic trading platforms in these markets has opened them up, making pricing and trading activity transparent to everyone. But the credit markets have remained closed and secretive, Bradley says. And today's regulatory structure—with the SEC overseeing stocks, the CFTC overseeing commodities and the U.S. Treasury overseeing the credit markets—reinforces what Bradley thinks are illusory distinctions among the markets.

"The notion that the commodities markets are somehow different in 2009 than equities and the credit markets is just baloney and bunk," he says. "The [only] difference is that they are in different divisions of the investment banks; different divisions that have different profit centers." Bradley says that the new regulatory structure should have all asset classes traded openly on electronic platforms that incorporate clearing.

Although everyone has an opinion, no one knows what that new regulatory structure will be. But certain concepts are emerging that are likely to be major components of the new structure. Through interviews with analysts and experts, SFO has identified five areas where important regulatory changes are likely.

1. CREATING A SYSTEMIC RISK REGULATOR

The most consistently mentioned reform is the creation of a systemic risk regulator. "It's going to happen, but the question is, how do you do it?" Zubulake says. Should it be an existing regulator, a combination of regulators, an entirely new agency? Inherent in the decision are political power plays among various agencies and the congressional committees that oversee them. It is no surprise, for example, that Barney Frank (D-Mass.), the chairman of the House Financial Services Committee, and Chris Dodd (D-Conn.), chairman of the Senate Banking Committee, have said that the Federal Reserve should have that role.

But some are wary of giving the Fed the job. Zubulake, for example, thinks the Fed already has too much on its plate. Instead, he proposes the decades-long idea of merging the CFTC and the SEC.

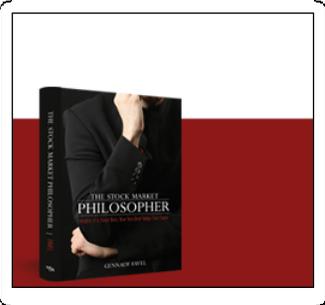
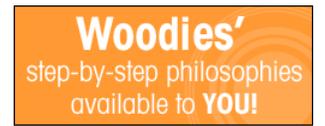
The latest idea—and maybe the most politically palatable—is to form a council of regulators. In testimony before Congress in May, FDIC Chairman Sheila Bair suggested a council consisting of the Fed, U.S. Treasury Department, FDIC and SEC be charged with keeping an eye on systemwide risks. She mentioned that it may be appropriate to add other prudential supervisors to this council.

And then there is the question of how and whether any systemic regulator's power can be global. Those companies that are typically "too big to fail" are those with multinational operations that make investments in markets around the world, so a systemic regulator with only U.S. authority might be ineffective.

2. TAXING TRADES

In February, Representative Peter DeFazio (D-Ore.) introduced a bill that proposes a 0.25 percent transaction tax on the "sale and purchase of financial instruments such as stock, options and futures." Although that bill is unlikely to go anywhere, the concept of a fee on transactions to help pay for the regulatory structure remains a possibility, according to Zubulake.

The SEC already...



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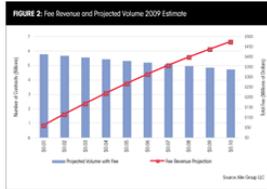
charges a transaction fee on equities, and the National Futures Association collects 1 cent per round turn trade on futures. Further increasing fees or instituting new ones could drive business out of the United States, he says. "In theory, if you tax them in the United States, they are going to move their business elsewhere, and take the liquidity with them," he says. Aite Group estimates the government could raise about \$59 million if it placed a 1 penny fee on Aite's projection of volumes this year for futures/options and equity options (see Figure 1). But for every penny fee, the potential loss of business in volume would equate to 2 percent (see Figure 2).

FIGURE 1: Revenue per Penny of a Transaction Fee

Instrument	Projected Volume	Revenue
Equity Options	\$362,740,199	\$36,274,019.90
Futures Options	2,873,876,544	\$28,738,765.44

Source: Aite Group LLC

click image for larger view



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Greg Hold, CEO of direct trading firm Hold Brothers LLC, agrees that a transaction tax would drive day traders out of the United States. A 0.25 percent tax per share on a \$50 stock, for example, would mean a fee of 12.5 cents per share, he explains. "But the average day trader makes less than a penny a share." By driving out the day traders, and thus liquidity in the market, the government would both chase away its tax base and dramatically widen spreads in stocks.

"They are just putting a bullet in the head of what's left of the American financial system if they do a transaction tax," Hold says.

3. MOVING OTC DERIVATIVES ONTO AN EXCHANGE

The idea of forcing OTC derivatives onto an exchange, or at least into clearing, gained steam this spring. In February, the House Agriculture Committee passed H.R. 977, the Derivatives Markets Transparency and Accountability Act of 2009. The bill includes a provision that mandates the clearing of all OTC contracts, requires reporting of OTC transactions to the CFTC and gives the CFTC the power to suspend purely speculative trading in credit derivatives if the underlying security is subject to a short-selling suspension order from the SEC.

In March, Treasury Secretary Tim Geithner, in his testimony before Congress, proposed moving the standardized parts of the OTC derivatives markets to a central clearinghouse and encouraging further use of exchange-traded instruments.

Then in May, senators Carl Levin (D-Mich.) and Susan Collins (R-Maine) introduced a bill that would repeal statutory prohibitions, including those enacted in the Commodity Futures Modernization Act of 2000, that currently bar government regulation of swap markets, which encompasses credit default swaps. If passed, this legislation would pave the way for federal regulation of all types of swaps, but it does not specify how swaps should be regulated.

Levin and Collins called the bill an "interim measure intended to clear the way for more specific swaps requirements" in financial reform legislation to come later this year.

Market forces, specifically growing fear of counterparties, were already moving OTC products toward a clearinghouse model, Zubulake says. For example, the SEC recently approved ICE Trust and CME Group to operate as central counterparties for credit default swaps, and ICE Trust has already begun to clear certain legacy deals through its clearinghouse, according to Zubulake's report....

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But a mandate forcing all OTC products into clearing and/or requiring them to be traded on an exchange would be problematic, he says, if not outright impossible. Currency and commodity markets are global, so trading could just move overseas, he says.

The Kaufman Foundation's Bradley, however, favors putting swaps and derivatives on an exchange and having them use a clearinghouse. It would provide the transparency the market needs to prevent what happened with credit default swaps. "That's what's been missing in this horribly ugly, horribly hidden market," he says. "I argue that the stress tests at the banks were an imperfect way of filling in for a clearinghouse. Clearinghouses are a far more effective way of assessing systemic risk than to have the Fed come in after the fact and try [to] clean up the mess."

4. RE-INSTATING AN UPTICK RULE

The SEC eliminated the uptick rule in July 2007. But the financial meltdown prompted the SEC to revive the regulation. In April, the SEC proposed two distinct approaches to short-selling restrictions. One method would impose a permanent, marketwide short-sale price test based either on the national best bid or on the last sale price or tick. The second approach would impose temporary short-selling restrictions on individual securities that experience severe price declines.

Hold does not believe short selling affects the long-term price of a stock and asserts that restricting short selling will drive traders to foreign exchanges. Furthermore, certain market makers in the past have been exempt from short-sale rules or have figured out legal ways around them, he claims. "We know from a lifetime in this industry that whatever rules the regulators create on short selling, somebody will find a legal way around the rules. So it just creates a caste system of haves and have-nots."

In 2003, for example, hedge funds were trading a derivative combination called a bullet that provided a way for them to sell short when others could not, Hold says.

5. NEW REQUIREMENTS

Finally, there is a raft of proposals to change or increase regulations for various players in the financial markets. The Bernie Madoff scandal highlighted the deficiencies in regulations governing investment advisers and broker-dealers. Investment advisers register with the SEC, broker-dealers with the Financial Industry Regulatory Authority.

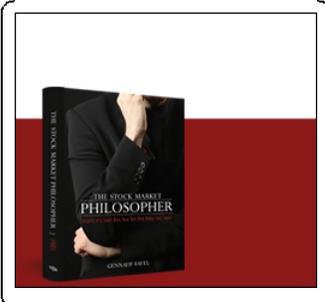
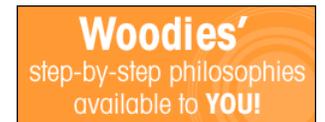
"There is no doubt that Madoff and others have cynically designed their schemes to fit between the jurisdictional cracks to decrease the likelihood of detection," Stephen Luparello, FINRA's interim CEO told Congress in February. "It does not make sense for two separate, independent regulatory bodies to oversee investment advisers and broker-dealers."

Meanwhile, Geithner has proposed requiring hedge funds with a certain amount of assets under management to register with the SEC. The government attempted to instate a similar requirement in 2006, but it was overturned by the courts, Zubulake says.

Although he expected the hedge fund community similarly to challenge any new rules, the Alternative Investment Management Association came out in favor of registration during congressional hearings May 7. Registration of hedge fund advisers would align U.S. and United Kingdom rules.

END GAME

With so many proposals in the wind, it is impossible to predict the exact changes the next year will bring. The only certainty is that the old regulatory structure is history. As for...



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the new one, in the best-case scenario, it will correct the biggest problems. Worst case: It further complicates what is an already incredibly arcane and complex web of rules, stifling innovation and market forces while leaving in or creating new loopholes that favor only a few market players.

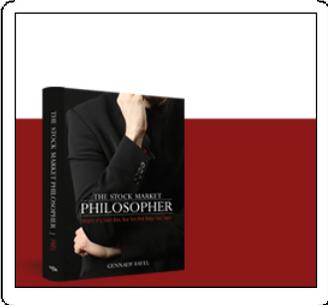
Tam Harbert is a freelance journalist based in Washington, D.C.

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