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Not So Fast, Mr. Paulson

The Chicago Mercantile Exchange objects strenuously to the Treasury Secretary's regulatory reform plan—and it's not afraid of a fight

by [Joseph Weber](#)

As Treasury Secretary Henry Paulson labors to overhaul the U.S. financial regulatory system, he could run into a buzz saw in Chicago. The broad-shouldered folks who run the Chicago Mercantile Exchange ([CME](#)) have handily fought off would-be interlopers in the past, whenever their freedom to do business as they like has been threatened. They blew away critics who said their board was too heavily packed with exchange-industry insiders, for instance. For years, they've shoved aside competitive threats from rival exchanges that tried to make inroads into their business. And they beat back a competitor that tried to thwart their purchase last year of the [Chicago Board of Trade](#).

They may just do the same now with the latest threat to the status quo for the CME: Paulson's far-reaching reform plan. Longtime observers argue that the parts of Paulson's Mar. 31 plan that could sharply rein in the free hand CME generally has are doomed. Most conspicuously, the idea of creating a new superagency that would put the CME's Washington overseer, the Commodity Futures Trading Commission (CFTC), under the same roof as the Securities & Exchange Commission (SEC), the stock-trading watchdog agency, is getting a chilly reception.

Charges of Lack of Understanding

The CME wasted no time in picking up the gauntlet Paulson threw down. A statement hurried out to respond to the former Goldman Sachs ([GS](#)) chief thundered against "an overly homogenized, less effective, and less competitive model" of regulation that it suggested could emerge from the Paulson plan. The outfit added pointedly that CME officials would work closely with all parties to make sure different regulatory approaches—one for its futures world and one for the stock world—are preserved. Exchange officials even got personal, saying Paulson's suggestion that certain rules governing stocks and futures ought to be

"harmonized" reflects a lack of "sufficient understanding" of differences in the markets. Blending them, it warned "is certain to cause more harm than good."

Indeed, the CME leaders hailed points Paulson made that seem likely to delay—or kill altogether—the idea of putting stock and futures exchanges under a single regulator. They welcomed the Treasury's suggestion that an SEC-CFTC merger required further study and isn't a short-term move, for example. And they agreed with Paulson's suggestion that the heavily rules-oriented SEC ought to shift to the lighter-touch governing philosophy, a so-called principles-based approach espoused by the CFTC. "Principles-based regulation in U.S. futures markets has spurred unparalleled growth, innovation, and competition," the CME leaders said.

An Alliance of the Regulator and the Regulated

The CME's tack is being echoed by leaders of the CFTC, whose gentle regulatory touch certainly has helped the exchange become the world-beating bourse in futures. While the creation of a single regulator could bring efficiencies, CFTC Acting Chairman Walt Lukken said in a statement, he warned that any reform "must preserve the benefits of the CFTC's principles-based model and recognize the distinct functions of the futures markets and the mission of the CFTC."

One particularly outspoken CFTC commissioner went even further in carrying the CME's message forward. "What I don't hear is a call from the countryside for moving boxes around in Washington, D.C., or the need for some omnipresent super-regulator," Commissioner Bart Chilton argued. "We shouldn't be about trying to cure what isn't sick."

Lukken even took the chance to toot his horn for the CFTC, which some observers say has a potent instinct for self-preservation and wouldn't want to disappear into the SEC: "The CFTC is a world-class regulator because of its focused mission, market expertise, manageable size, problem-solving culture, and global outlook—all of which may be jeopardized with the creation of a large regulatory bureaucracy."

Industry observers say officials at the CFTC and the CME share a common interest in ensuring that little really changes. "There may be strong vested interests to stay with the status quo," says Michael Pagano, a professor of finance at Villanova University who follows the exchanges. "That is what has defeated things in the past."

Worlds Blurring, Converging

Still, the financial meltdown that has swept away Bear Stearns ([BSC](#)) and is now threatening much of Wall Street could reorder the alphabet soup of agencies in Washington—if Paulson can overcome the power of united bureaucratic and commercial interests. Pagano argues that distinctions between the stock and futures worlds are blurring, and he points to the CME's recent acquisition of

[Credit Market Analysis](#), a London outfit that will let the CME move into the over-the-counter world for credit derivatives. Such products, he says, are similar to the structured financial products involving mortgages that got Bear Stearns and other investment banks in big trouble.

Moreover, some of the players in the battle over the regulatory overhaul are lining up on different sides. NYSE Euronext ([NYX](#)), for instance, supports Paulson's plan. The parent of the New York Stock Exchange argues that "greater regulatory convergence, in the U.S. and abroad," would better serve U.S. capital markets, a spokesman for the bourse says. It'll be tough to achieve in the short-term, the New York exchange argues, but would be worthwhile over time.

NYSE Euronext has its own vested interest in such "convergence." While the CME has largely stayed out of the stock markets, NYSE Euronext is increasingly moving into futures and derivatives. It has a big futures operation in Europe, picked up a big options business—another form of derivative—by buying the American Stock Exchange, and is now buying the gold and silver futures business of the CME's Chicago Board of Trade unit. NYSE Euronext would prefer to deal with a single regulator, rather than answer to two separate masters. Commonly in Europe, it deals only with single regulators in both arenas.

Change-Resistant Forces

Even if a single superagency emerges in Washington, just how powerful it will be is hardly clear. Some analysts say the regulatory overhaul could wind up weakening the SEC, on whose watch Bear Stearns collapsed after all. [Sandler O'Neill & Partners](#) analyst Richard Repetto argues that the CFTC's "principles-based" tack is likely to prevail and that any combination of the CFTC and SEC wouldn't be an "automatic negative" for the exchanges.

In the end, however, the lame-duck Bush Administration and its lame-duck Treasury Secretary almost certainly will wind up handing the idea of such reforms over to the next Administration. "Right now, we're just looking at something that is just a discussion piece," says [Zacks Investment Research](#) analyst Charles Rotblut, who is skeptical that any real change will take place. As the discussion proceeds, the powerful lobbying forces of the CME and other big players will surely press their cases against too much change.

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