STATEMENT
OF
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BEFORE THE
UNITED STATES SENATE COMMITTEE ON BANKING,
HOUSING AND URBAN AFFAIRS

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Mr. Chairman, I appreciate your invitation to testify before the Banking Committee this morning on the "Capital Markets Competition, Stability and Fairness Act of 1990." This legislation represents an important and necessary reform of our current system of regulating both the equity and futures markets.

For almost three years (1987-1989) I served as a member of the Board of Governors of the Chicago Mercantile Exchange. I resigned from the Merc Board in November of last year. I came to the considered belief that the Merc was being operated by insiders for the benefit of insiders, and that Joe Average Guy was not getting a fair shake. The "final straw" in terms of triggering my resignation was the way the Merc and certain of its principals handled --- I should say 'mishandled" --- the CFTC fraud investigation involving Brian Monieson, a former director and chairman of the Merc, and his firm, GNP Commodities, Inc. In May of this year, Mr. Monieson, GNP Commodities, and two of the firm's brokers were fined and permanently barred from the futures industry.

While the Monieson matter was the immediate and proximate cause of my resignation from the Merc's Board, the Merc's handling of the affair was merely symptomatic of much broader ailments affecting the regulation of our country's futures exchanges. Stated quite simply, the current system of "self regulation" -- which the

Chicago exchanges tout as the be-all and end-all in assuring the integrity of the futures exchanges -- does not work. I state this flat out. The futures industry deals in billions and billions of dollars and millions and millions of transactions each year. In terms of its fiduciary relationship to the public, the futures industry is akin to a bank or a savings and loan institution. No one in this day and age would espouse that the banking or S&L industry be collectively self-regulated.

Compounding the failure of "self-regulation" is the benign and timid supervision of the futures exchanges by the CFTC. The CFTC is about as sluggish a regulatory agency as one can find. It's about as zesty as the Federal Election Commission. Alone among federal oversight agencies, it has to be reauthorized every three years. Thus, the CFTC members live in mortal fear of the exchanges they regulate -- fear that the exchanges will ask Congress to either terminate the Commission at its next reauthorization date or somehow further restrict its limited authority or its paltry budget.

Perhaps 90 to 95 percent of the Commission's professional staff time is tied up with processing routine, albeit necessary, work. Only the remaining time -- and as few as 25 to 35 people -- are available to respond to major policy and investigatory matters affecting the futures industry. The Chicago sting operation in the futures pits by the Federal Bureau of Investigation produced 46 indictments against traders in 1989. After the sting, the CFTC, this pygmy of federal regulation, overwhelmed by its day-to-day operations, came plodding along with too-little, too-late to catch fast-moving crooks and fast-changing events.

As I testified before the Senate Agriculture Committee last October, in my view, S. 1729, the CFTC reauthorization bill reported by the Agriculture Committee last fall,

goes a long way toward correcting several of the more serious ills affecting the futures industry. For example, the provision of S. 1729 requiring development of a verifiable, electronic audit trail is a critical first step toward curbing the abusive self-dealing that the "open outcry" system has facilitated. As long as the existing system of open outcry remains, there will be substantial cheating at the futures exchanges. The exchanges have to be brought into the 21st century with an electronic trading system that leaves a verifiable audit trail.

While the excellent work of Senator Leahy, Senator Lugar and the Agriculture Committee has produced the beginning of a package of important and necessary futures reforms, we must go farther in reforming regulation of the Nation's financial markets.[*] I am convinced that the Administration's proposal to shift jurisdiction over stock-index futures to the Securities and Exchange Commission will have a positive effect, not only on the markets for equities and equity-derivatives, but on the nation's commodity futures markets as well.

A point that has been overlooked in much of the recent debate concerning the Administration's proposal is that the transfer of jurisdiction over stock-index futures to the SEC will free a good deal of the CFTC's staff and resources to focus on the Commission's unique and historic mission -- to ensure fair and stable futures markets for the Nation's physical commodities, both agricultural and otherwise. The Commission's regulation of stock-index futures -- commencing in 1982 -- has diverted the agency from the original purposes Congress had in mind when the CFTC was created.

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[*] My major objection to the Leahy-Lugar package is its failure to ordain a phase out of "open outcry" in favor of a modern, verifiable electronic system.

I was a member of the Senate when the CFTC Act was enacted in 1974. Congress acted out of an overriding concern that the country's farmers, producers and consumers must be provided with a futures market that was fair, evenhanded and efficient. As the Senate Agriculture Committee stated in its report on the CFTC Act:

> In recent years, the consumer has become increasingly aware that futures markets have a direct effect on such matters as his grocery bill and the cost of his home . . . In order to assure that futures markets operate properly and that the prices consumers pay are not artificially high, careful and efficient supervision of the markets is essential . . . . If individual speculators or groups operating in concert obtain control of the futures markets, price manipulation, corners and squeezes can occur, with adverse effects on producers and consumers alike.

The world of stock-index and other financial futures was neither contemplated nor foreseeable at that time. The CFTC was created to ensure the integrity and stability of the commodity futures markets -- a purpose no less important today than it was in 1974.

Beginning in 1982, however, the attention of the CFTC and its staff has increasingly and understandably been turned away from the critical job of regulating futures on agricultural products and other physical commodities. Instead, the CFTC has focused its increasing time and its meager resources on the more exotic world of stock-index futures and other financial products. I believe that the interests of America's farmers, producers and consumers, as well as its investors, have suffered as a result.

I do not have to remind my friend, Senator Bond, or other farm state senators of the turmoil created a year ago in the futures markets by the Ferruzzi fiasco -- when the Chicago Board of Trade issued an order forcing traders into a huge sell-off of soybean futures contracts. That order cost American farmers millions of dollars as soybean prices entered a free-fall.

There can be little doubt that episodes like the July, 1989 soybean order and the FBI sting on Chicago's trading pits have shaken the confidence of America's farmers, ranchers and consumers in the integrity of the futures markets and in the effectiveness of the CFTC. By shifting the regulatory jurisdiction over stockindex futures to the SEC, Congress will be at least partially restoring the CFTC to its statutory mandate: the regulation of commodity futures trading. With its efforts and resources focused more sharply on this important mandate, the CFTC will be better able to serve the interests of America's farmers and ranchers whose livelihoods are affected by each twist and turn of the commodity futures markets.

The Administration's proposal will also provide needed reassurance to individual investors in our equity markets. The market breaks of October 1987 and 1989 have shaken investor confidence and jeopardized capital formation in America's markets. Investors understand that the stock-index futures markets exert a strong and often volatile influence on the markets for their underlying securities. Indeed, we are all too often reminded of the inextricable connection between these markets.

Just a couple of weeks ago, on Friday, June 22, for no obvious reason, the Dow Jones Industrial Average plunged more than 60 points in less than 1-1/2 hours of trading. According to an article in The Washington Post, "[c]ash markets and futures analysts were stunned by the late, program trading whipsaw -- perhaps the most volatile futures related trading since . . . the October 13, 1989, 'Friday the 13th' massacre . . . ."

The Administration's proposal to consolidate authority over stock and stock-index futures under the SEC will permit a more rapid, coordinated and flexible regulatory response to such market disruptions. A single federal regulator of equity and equity-

derivative products will be better able to address critical intermarket trends and problems -- hopefully avoiding or at least minimizing the destructive impact of market disruptions on individual investors and other market participants. The Administration's proposal offers sound and workable reforms that will provide a unified regulatory framework to address stock market volatility and help restore investor confidence in the Nation's capital markets. We cannot afford to sit idly by and wait for the next big market crash.

Finally, and quite bluntly, as long as stock-index futures remain under the jurisdiction of the CFTC and thereby overwhelm the CFTC's efforts, there will be an aroma of distrust in the minds of the trading public as to the scope and vigor of market surveillance. There's an old and respected stockbroker in St. Louis who puts it this way, "Those Chicago boys are too slick for the sleepy CFTC."

Mr. Chairman, the CFTC is underfunded, underenthused, and overwhelmed. It may be a good thing for professional baseball to be split into two leagues. It makes no sense for equity or equity derivatives to be split into two varying regulatory playing fields.