

Statement of  
Dr. Wendy L. Gramm  
Chairman  
Commodity Futures Trading Commission  
Before the  
Senate Committee on Agriculture,  
Nutrition, and Forestry  
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Mr. Chairman, I welcome this opportunity to appear before this Committee to present the views of the Commodity Futures Trading Commission (CFTC) regarding futures regulation and jurisdictional issues. Those of us charged with making policy choices must be careful to distinguish fact from rhetoric. The legitimate goal of international competitiveness for all United States markets should not be confused with the parochial claims of competing domestic market interests. And we must keep in mind the very different functions served by capital formation and risk-shifting markets.

Let me turn to the issue before us today -- whether to redraw the jurisdictional lines between the CFTC and the Securities and Exchange Commission (SEC) in an attempt to (1) diminish stock and derivative market volatility,

(2) facilitate innovation, and (3) better police our markets against manipulation.

The Commodity Futures Trading Commission opposes any change in jurisdiction, including a shift of jurisdiction for stock index futures, financial futures, or a merger of the SEC and the CFTC. A change in CFTC jurisdiction will not solve any of the real issues our financial markets face today. Furthermore, the Commission believes that, unfortunately, our reauthorization legislation, which includes much needed market reforms, is being held up in the Senate because of a continuing and unnecessary jurisdictional battle.

To be sure, financial markets and their regulators face some important issues. These issues include the long-term decline of United States prominence in world equity markets, the long-term decline in retail securities brokerage business, short-term stock market volatility, and intermarket concerns, such as circuit breakers and the systemic risk in clearing, settlement, and payments. These issues do not exist because of the jurisdictional boundaries between the CFTC and the SEC -- nor will a change in jurisdiction resolve them.

Under the existing regulatory framework, the U.S. has the most liquid, most innovative and largest futures markets in the world. That framework has allowed futures markets to

successfully adapt to economic change and will continue to do so. In 1960, 3.9 million futures contracts were traded in the United States. By 1980 that number had grown over 20 fold -- to 92 million contracts. During those 20 years, futures markets created new contracts to respond to rapidly changing economic conditions that came with floating exchange rates, rising interest rates and an increasingly global marketplace. By 1989, over 267 million contracts were traded, most recently reflecting growth in stock index futures and in the Eurodollar futures markets. In 1989, agricultural futures accounted for over 20 percent of total trading volume and was 68 per cent more than total futures volume during the Commission's first year, 1975.<sup>1</sup>

This growth has not been accidental. For well over a century, American farmers and agricultural processors and merchants have realized the importance of futures markets for efficient price discovery and hedging. They discovered that futures and cash markets were linked and that this linkage allowed them to use futures markets to hedge price risk and lock in the price of grain in the months ahead. More than a century later this "discovery" became apparent to financial managers who sought ways to hedge price risk for their cash market inventories and portfolios. Today, futures markets are successfully used by

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<sup>1</sup>Futures Industry Association, Inc., 1990. Futures Contracts Traded by Commodity Group.

producers, merchandisers, commercial institutions, institutional investors, fund managers and many others to manage the risk associated with changing cash market prices.

Today, the CFTC regulates more than 80 active futures contracts. Twenty-seven of these, or about one-third, are based on agricultural commodities, 19 are based on precious metals, energy and other physical commodities and 35 are financial futures--interest rate, stock index and foreign currency contracts. Let me stress two important characteristics that all these commodities share despite differences in pricing structure and economic fundamentals: (1) in each case, the cash market is linked to a futures contract, and (2) such contracts are traded and regulated in the same way.

The point is not that the futures market is linked to the stock market--all futures markets are linked to a cash market. The fact that these markets are linked, however, does not mean that cash and futures markets serve a single purpose, should be regulated in the same way or by the same regulator. Nor does it mean that the separate components can operate safely or successfully under the same rules. Each futures market serves a different purpose from its underlying cash market.

Indeed, in 1974 Congress recognized this truth and separated agricultural futures regulation from agricultural cash market

regulation. When Congress established the CFTC as an independent agency, it recognized not only the functional differences between the cash and futures markets, but also the potential conflicts of interest that could arise. As the General Accounting Office observed at the time:

A potential conflict of duties and responsibilities might exist if the Commission were located within the Department of Agriculture, and chaired, on a permanent basis, by the Secretary of Agriculture, who is charged by law to influence and maintain the prices of many of the commodities traded in the futures markets. (H.R. Rep. No. 93-975 at 60).

The perceived policy goal of the USDA for stable or higher agricultural cash commodity prices is similar to the SEC's interest in stable or higher stock prices. However, the futures regulator must be insulated from any price bias in order to maintain price neutrality. A fair and open hedging market must be price neutral. Futures regulation cannot favor longs over the shorts. Unlike the SEC, the CFTC does not have an uptick rule for short selling. Nor does the CFTC have a rule permitting traders to prevent or retard only falling prices as does the SEC for "stabilizing" market prices of new stock issues. In fact, the CFTC can take emergency action when prices do not reflect the forces of supply and demand, regardless of whether prices are rising or falling.

Congress has tailored a regulatory framework to facilitate the special purposes and functions of the futures markets. The Commodity Exchange Act reflects the special risk-shifting

functions of futures transactions and provides market and customer protections distinct from those applicable to securities and other cash markets.

Futures contracts must undergo an approval process before they are allowed to trade that has no counterpart in the securities laws. Exchanges seeking to trade a new contract must first demonstrate that trading "will not be contrary to the public interest," that is, that it will serve an "economic purpose." In practical terms, the contract must serve a price basing or hedging use on more than an occasional basis. The Commission reviews each proposed futures contract to determine whether the exchange has demonstrated adequately that the proposed contract serves an economic purpose, has addressed the possible susceptibility of the contract to manipulation, and that other relevant public interest concerns have been satisfied.

In addition, the Commodity Exchange Act requires that customer funds be segregated; authorizes the Commission to establish a "large trader" reporting system; provides authority to impose speculative position limits; and establishes a customer reparations forum at the Commission. These aspects of the futures regulatory system also find no counterpart in the securities regulatory system.

## Current Jurisdiction -- Is It an Obstacle to Effective Regulation?

United States futures markets serve as models for other countries developing agricultural, energy and financial futures and options products, just as the CFTC serves as a model for other countries developing futures market regulatory systems.

The success of these markets and the existing system is borne out by the evidence of market performance and regulatory achievements. There is no evidence that current jurisdictional boundaries impede successful regulation -- whether done independently or in cooperation with other agencies. Let's examine the record.

1. Trade Practice Surveillance. In recent years, the CFTC has taken significant action involving trade practice surveillance:

- o One-minute Audit Trail. We required exchanges to implement one-minute audit trail systems. These systems allow prompt reconstruction of trading activity including essential information about both sides of each trade. This audit trail permits futures exchanges and the Commission to reconstruct and analyze trading patterns quickly. This system was instrumental in reconstructing trading activity immediately after the October 1987 market crash and after other high volume

trading days. Nothing comparable to it exists in the securities industry.

- o Improved Floor Surveillance and Trade Practice Investigations. We monitor trading through trade practice investigations and direct "pit patrols." We have increased staff presence on exchange floors and enhanced our electronic database system to assist in investigations.
- o Public Exchange Rule Enforcement Reviews. CFTC rule enforcement reviews are part of our trade practice oversight program. This program encourages exchanges to remedy deficiencies promptly.

2. Trade Practice Rules. The CFTC also acts expeditiously when problems occur. For instance, within the last year, we have taken significant regulatory actions based upon information obtained in the recent Chicago undercover investigations and through other regulatory activities.

- o Improved Accuracy and Integrity of Audit Trails. We wrote new rules to improve the accuracy and integrity of exchange audit trails by requiring improved recordkeeping procedures for audit trail systems.

- o Restricting Certain Exchange Members from Committee Service. We wrote a new rule to prohibit persons with significant disciplinary histories from serving on specified exchange committees and boards.
  - o Dual Trading. We completed a comprehensive study of the effects of dual trading which prompted proposed rules to implement a plan to restrict dual trading.
  - o Broker Associations. We completed a study of broker association practices which prompted proposed rules requiring registration of these associations so that their activities may be better monitored.
3. Clearing and Settlement. The CFTC has also addressed clearing and settlement issues arising out of the 1987 market break.
- o Settlement Bank Agreements. We monitored the development of new agreements designed to clarify the obligations of banks to futures clearing organizations in making margin settlements.
  - o Reduced Reliance on Letters of Credit. We encouraged futures exchanges to increase the liquidity of clearing organizations' guarantee funds by reducing reliance on

letters of credit and by developing procedures to prevent excessive concentrations of letters of credit issued by any one bank.

- o Improved Exchange Margin Payment Procedures. We encouraged development of procedures to pay out and collect margin on a routine intra-day basis, thereby reducing variation margin flows at the daily morning settlement.
- o Improved Information Sharing. We encouraged all futures clearing organizations to enter into a Market Information Sharing Agreement for the routine electronic sharing of margin pay and collect information on a daily basis. In October 1989, the Options Clearing Corporation, the clearing organization for all equity options, also entered into this agreement.
- o Improved Financial Surveillance. We are developing a database using CFTC large trader reports and open position data to monitor the effect of price movements on FCM capital across all futures markets and for other financial surveillance purposes.

4. International Trading. The CFTC has also addressed issues involving the sale of foreign futures and options to U.S. customers.

- o Foreign Futures and Options. We have extended existing CFTC customer protection rules to United States purchasers of foreign futures and options from five different jurisdictions. Certain persons located outside the United States are permitted to seek an exemption from some CFTC rules if they comply with their foreign regulatory program and if the foreign regulators agree to share financial and trade information with the CFTC.
  
- 5. Market Innovation. We have taken significant steps to support market innovation:
  - o Trading Methods. The Commission approved Globex, a screen trading system proposed by the Chicago Mercantile Exchange to initiate 24-hour cross-border trading. In our review, we considered access to Globex terminals, order entry and execution, clearing and margin, the CME-Reuters relationship, compliance systems, computer security, systems failures, and the applicability of United States law. A similar review of Aurora, a computerized trading system proposed by the Chicago Board of Trade, is also under way.
  
  - o Off-Exchange Instruments. In addition to encouraging innovations in exchange-traded products, in 1987 the CFTC established a task force to review and

accommodate, within the framework of the existing Commodity Exchange Act, recent innovations in the area of off-exchange hybrid debt and depository instruments. We have succeeded in achieving this goal through rulemaking, statutory interpretation, a policy statement, and no-action letters. We worked with other agencies to avoid litigation, avoid regulatory gaps, and reduce regulatory uncertainty that existed in these markets -- uncertainties that stood as an impediment to further innovation.

#### Regulatory Coordination

The CFTC's programs are coordinated with other government agencies in a variety of ways. Since all futures trading involves hedging and price discovery, the CFTC keeps apprised of cash market commercial practices for many different commodities as it approves contracts and monitors trading. This requires frequent contact with regulators of diverse cash markets. Thus, the CFTC has information-sharing arrangements with the Departments of Agriculture, Energy and Treasury, and since the advent of stock index futures, with the SEC. Through the use of its large trader reporting system, the CFTC conducts market surveillance independently and in coordination with other agencies and self-regulatory organizations.

With regard to the financial markets specifically, the CFTC, SEC, Treasury Department, and Federal Reserve System staffs meet periodically to review upcoming contract liquidations and share other information about trading activity. The CFTC and SEC coordinate intermarket trading issues through a number of means, including (1) meetings with the Intermarket Surveillance Group, composed of the securities and futures exchanges that trade stock index products; (2) participation in the Intermarket Network for Futures, Options, and Equities, an open dedicated phone line designed to simultaneously share important market news and developments among the exchanges; and (3) through agency surveillance staff contact to share data and information concerning securities and stock index futures markets as the situation warrants.

On several occasions, the CFTC and SEC staffs have conducted joint interviews with major traders to determine the nature of various trading strategies and their impact on the markets. The New York Stock Exchange and the Chicago Mercantile Exchange also now exchange certain confidential trade information on a routine basis. The Chicago Board of Trade is expected to conclude a similar agreement with the New York Stock Exchange. Sharing market data enables the exchanges to perform regular, computerized surveillance for intermarket frontrunning and other trading abuses.

Financial surveillance is also being coordinated. The Joint Audit Committee, comprised of representatives of the futures exchanges and the NYSE, distributes futures market auditing responsibilities among all participants. In addition, the CFTC and SEC have developed and authorized consistent capital requirements for brokers. Also, the two agencies have permitted members of both securities and futures exchanges to file certain SEC financial reports with the CFTC instead of completing duplicative reports. Further coordinating initiatives are in progress.

The CFTC has worked with other agencies and the President's Working Group on Financial Markets to address clearing and settlement issues. We have coordinated with the SEC in approving two intermarket cross-margining programs. Cross margining permits persons who trade in related markets to calculate their margins based on their combined risk exposure in both markets. We also fostered development of an information-sharing system in which all futures and securities clearing organizations can participate to provide a basis for risk assessment across markets.

In sum, the present allocation of jurisdictional responsibility has not been an obstacle to effective regulation. This is not to say that existing laws are perfect. Important and necessary market reform legislation for both the securities and

futures industries is presently pending before Congress. In this regard, Mr. Chairman, I echo your call that the Senate act promptly to pass S. 1729, the Futures Trading Practices Act of 1989. The CFTC and the public interest require enactment of needed statutory improvements to sustain confidence in the markets and to enhance existing regulatory systems. What has not been demonstrated, however, is the need to shift jurisdiction from the CFTC to the SEC or to merge the agencies.

#### No Case for Change

Despite the fact that no substantive justification for a shift in CFTC's jurisdiction has been made, we continue to hear a call for jurisdictional change. All the alternatives suggested: 1) shift stock index futures jurisdiction from the CFTC to the SEC, 2) shift jurisdiction over all financial futures to the SEC, and 3) merge the SEC and the CFTC into some new super agency, would result in a radical restructuring of current regulatory systems. Yet fundamental questions, that would ordinarily precede such a radical restructuring, remain unanswered. These questions include:

- o What problem is the proposed shift in jurisdiction supposed to fix?
- o What would such a shift in jurisdiction accomplish?
- o What specific policies will be altered as a result of a change in jurisdiction? In other words, what would be done differently? And how?
- o What are the possible unintended consequences of a jurisdictional restructuring?

Recently, we have been told that a handful of problems exists and that deficiencies exist in the current regulatory system. These claims include:

- o Stock index futures and related trading strategies have driven the individual investor from the stock market and impaired its capital raising function.
- o Trading stock index futures causes increased stock market volatility.
- o Margins on stock index futures are too low and are inconsistent with cash market margins. As a result, market volatility is increased and market declines are exacerbated.
- o Separate regulators can not effectively police intermarket frontrunning.
- o The existence of two agencies in the United States to regulate securities and futures markets puts us at a disadvantage in international negotiations with the regulators from other major countries, all of whom have a unified system of regulation.
- o The futures industry and the CFTC stifle innovation, most recently preventing index participation units (IPs) from trading in the United States.

Are these so-called problems real? Does the regulatory "wonder-cure," reducing the CFTC's jurisdiction by increasing that of the SEC, solve the problem? Are there any side effects

to this "wonder-cure?" Let's examine each of these claims and consider the facts. Facts, not assertions, are necessary to distinguish between true market reform and regulatory imperialism.

1. **Stock index futures and related trading strategies have not driven the individual investor from the stock market.**

The evidence is clear. Stock index futures are not driving the individual investor from the stock market. Direct stock market participation by individuals has indeed declined, but the decline began decades ago and is part of a transformation of the financial service industry around the world. In the 1960s and 1970s households shifted their asset holdings away from direct equity investments. For example, in 1968 households held 33 percent of their assets directly in stocks; by 1974 they held only 15 percent of their assets directly in stocks, and that fraction has been roughly constant for the last 15 years.<sup>2</sup> The retreat, then, occurred well before stock index futures and program trading appeared on the scene.

The trend away from direct individual investment has been accompanied by a long-term increase in equity holdings by pension funds and other institutional investors. The inevitable consequence of this shift from households to institutions is a

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<sup>2</sup>SEC memorandum, November 6, 1989. From Office of Economic Analysis, based on Federal Reserve Board, Flow of Funds Report.

shift in trading methods. Retail trading has declined dramatically just as block trading and other trading strategies have become more prevalent. The truth, then, is that the individual investor is still in the market, participating through institutions such as pension funds and mutual funds. And the risk associated with institutional positions in the stock market is frequently managed with futures contracts.

2. Stock index futures trading does not increase stock market volatility.

There is no credible evidence to support the contention that futures trading contributes to excessive volatility in the cash market. More volatile cash markets tend to have more active futures markets because cash market volatility increases the desirability of taking futures positions, not the other way around. The overwhelming consensus of many academic studies is that futures trading does not contribute to cash market volatility.<sup>3</sup> In fact, there is an emerging consensus that cash market volatility actually falls upon the introduction of futures.

3. Raising stock index futures margins would not lower stock market volatility.

Since margins serve fundamentally different purposes in the futures and securities markets, there is no reason why they

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<sup>3</sup>Clifford Smith and Charles Smithson, "Derivatives and Volatility," Intermarket, 1989.

should be set at the same levels. Futures margins are good faith deposits -- performance bonds -- set and required by exchanges and brokers to insure that buyers and sellers of futures contracts meet their respective financial obligations. Stock margins are not a performance bond but rather are a downpayment that limits the maximum credit that can be extended.

Less than two years ago, the Working Group on Financial Markets unanimously agreed that stock margins must be significantly higher than futures margins to provide the same level of financial protection.<sup>4</sup> The proof that the existing futures margining system works well is unequivocal. No futures clearing member firm defaulted in either October 1987 or October 1989.

In the face of such overwhelming success, the claim nevertheless has been made that futures margins, relative to stock margins, increase stock price volatility. Three assertions are advanced: (1) the high leverage due to low futures margins allows indirect, highly leveraged access to the stock market which leads to volatility; (2) the payments system is strained by demands for futures margin in times of extreme price fluctuations; and (3) margined futures traders are forced to sell to meet margin calls causing liquidity to vanish. Careful examination of each of these assertions has been unable to find supporting evidence.

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<sup>4</sup>Interim Report of The Working Group on Financial Markets, (Washington D.C.: Government Printing Office, 1988), 2.

(1) Leverage and volatility. Research conducted by economists at the SEC and the Federal Reserve Board, among others, finds no significant evidence of an inverse relationship between margins and volatility.<sup>5</sup> Direct research on margin policy in stock index futures is limited because stock index futures contracts only began trading in 1982. The two extant studies directly on the topic did not find that low margins lead to high volatility.

Nor does the evidence support the assertion that the stock index futures market is more highly leveraged than the stock market. Because of the different settlement periods, it is possible for there to be greater leverage for a player in the stock market than for one in the futures market. And, at times there is much greater opportunity for leverage in options on individual stocks than there is in the market for stock index futures. Moreover, the stock index futures market is used predominantly by institutions to hedge their cash market portfolios.<sup>6</sup> But a cash portfolio position hedged with a futures

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<sup>5</sup>See Dean Furbush and Annette Poulsen, "Harmonizing Margins: The Regulation of Margin Levels in Stock Index Futures Markets," Cornell Law Review 74 (July 1989): 873; and Paul Kupiec, 1989, Federal Reserve Board, Washington, D.C.

<sup>6</sup>According to a Stanford University economist, Jeffrey Williams, "[t]he salient feature of futures markets is precisely the frequency with which positions in futures contracts are combined with other positions." Jeffrey Williams, The Economic Function of Futures Markets (New York: Cambridge University Press, 1986), 41.

position is not leveraged, regardless of the level of futures margins.

(2) The strained payment system. In 1988, the Working Group found margins were set at prudential levels. The futures markets already meet or exceed the relevant recommendations to improve clearing and settlement systems made by the Group of Thirty for securities markets. Moreover, many improvements to the futures clearance and settlement systems suggested by the Working Group have been made already or are underway.

As long as settlements and payments continue to occur at different times for related positions there will continue to be systemic risk in the markets. The CFTC and the SEC have a good working relationship in these areas, having worked together on a number of measures.

(3) Selling to meet margin calls. This argument contends that traders are initially attracted by low futures margins and that adverse price movements prompt margin calls which force selling that would not otherwise have occurred. The argument suggests that futures traders must close their positions on volatile days to meet margin calls, prompting a decline in open interest for the futures contract as a whole and particularly for the affected group. An examination of the magnitude of open interest in the S&P 500 stock index futures contract on high volatility days contradicts the supposition that margin call sell-off exacerbated the market decline. On both October 19, 1987, and October 13, 1989, open interest at day's end was higher

than on the previous day--more positions were opened than were closed.

Furthermore, on October 13, only one of the 60 largest net position changes represented long liquidation by a speculator -- the speculator was a large commodity pool. Based on the fact the commodity pools typically hold a very large proportion of their total customer funds in short term interest bearing instruments, this sell-off was most likely responding to signals from a technical trading system, not to a variation margin call.

**4. Separate regulators can effectively police intermarket frontrunning.**

There is no concrete evidence that intermarket frontrunning -- that is, trading in one market while in possession of material non-public information about another market -- or any other intermarket trading abuse poses a significant threat to market integrity.

Within the securities industry, different stocks and option markets have developed intermarket surveillance techniques to detect frontrunning without requiring the merger of exchanges. Futures exchanges also have established inter-exchange surveillance procedures to actively monitor trading patterns for intermarket frontrunning. The enforcement divisions of the CFTC and SEC share information in a cooperative relationship and, indeed, have filed joint enforcement actions in other areas. We see no reason why this relationship will not continue regarding intermarket frontrunning and other intermarket abuses.

5. The existence of two agencies in the United States to regulate securities and futures markets does not put us at a disadvantage in international negotiations with the regulators from other countries.

To the world at large, the CFTC and the SEC are regarded as the leading regulators of futures and securities markets.

Witness the times the CFTC has hosted delegations of foreign regulatory authorities who have a desire to learn how the most successful futures markets in the world are regulated, or the number of commodity futures statutes in effect in foreign countries which are patterned on the United States Commodity Exchange Act.

Our markets have prospered under the current regulatory structure. We see no reason to change our system to parallel systems of less experienced foreign authorities. In fact, while some other countries' regulators may appear in their organizational charts to have only one agency in charge of securities and futures products, in practice bilateral negotiation often means working with several bureaus or divisions within the same governmental organization.

Furthermore, there is no uniformity of regulatory structures among foreign regulators. A careful examination of the regulatory structure of different countries reveals a wide disparity of regulatory approaches across countries and a substantial degree of regulatory fragmentation within countries, particularly in those countries with the largest futures markets. For example:

- o In Japan, three ministries, the Ministry of Finance, the Ministry of International Trade and Industry, and the Ministry of Agriculture, Forestry, and Fisheries administer three statutes which govern the Japanese securities and futures markets. Within the Ministry of Finance, two bureaus separately regulate financial futures and securities futures.
  
- o In the United Kingdom, responsibility for regulating futures and securities business is vested in the Department of Trade and Industry, the Bank of England, the Securities and Investments Board, and specialized self-regulatory organizations such as the Association of Futures Brokers and Dealers and The Securities Association. Regulatory overlap is addressed by ensuring coordination and cooperation among regulators.
  
- o In France, numerous laws govern futures and securities transactions and are administered by the French Ministry of Finance, the Commission des Operations de Bourse, an independent regulatory agency, and two legislatively created bodies, the Conseil de Marche a Terme (CMT) and the Conseil des Bourses de Valeurs (CBV). The CMT and CBV have primary responsibility for supervising the activities of, and transactions on, the futures and securities markets, respectively, and have unique rules and regulations

applicable to the markets which they regulate. The Bank of France also has relevant regulatory responsibilities.

To my knowledge, neither the SEC nor the CFTC has been impeded in its dealings with foreign regulatory authorities. On the contrary, both agencies have agreements with foreign jurisdictions encouraging information sharing and regulatory cooperation. In fact, the CFTC has led the way in developing financial and compliance information-sharing agreements.

It is hard to imagine how an SEC-dominated agency would be more effective at maintaining our competitive edge. Since 1975, United States equities have declined from about 63 percent to only about 29 percent of the world equity markets,<sup>7</sup> while the futures market still boasts a world market share of 70 percent.<sup>8</sup> It is interesting that the regulator whose industry has fared the worst internationally wants to take over the more successful industry in the name of international competitiveness.

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<sup>7</sup>Testimony of Louis Margolis, Managing Director, Salomon Brothers, before the CFTC Financial Markets Advisory Committee, November 1989.

<sup>8</sup>Chicago Board of Trade, 1989. "A Review of the Amount of U.S. Futures Business Left to Foreign Exchanges as a Result of Oversight Regulations in the United States."

6. The futures industry and the CFTC have not stifled innovation. In fact, the CFTC worked to accommodate IPAs trading.

The most surprising argument now being made is that the CFTC and the futures industry stifle innovation. The CFTC's record on encouraging and accommodating innovation in financial products and trading systems is excellent. The United States futures industry has been the leading innovator of financial products, many of which it created within the past fifteen years. This impressive growth of new products and also whole new trading systems could not have occurred in an atmosphere that stifled creative thinking and frowned upon new ideas.

Since we are discussing the possibility of shifting jurisdiction to the SEC, it is appropriate to examine the record of support for innovation, particularly regarding derivative products, at the SEC. If the CFTC had not been a separate independent agency during the past 15 years, would we have seen the growth in products that has made the United States the financial futures and options center of the world? It is doubtful.

In 1975, the SEC threatened to go to court to prevent the Chicago Board of Trade from launching its GNMA futures contract. In 1978, the SEC unsuccessfully sought from Congress the CFTC's financial futures jurisdiction. In the early 1980s, the SEC opposed the introduction of stock index futures because it believed they served "no economic purpose." But by 1982 the SEC

was seeking jurisdiction over stock index options, and by 1988, jurisdiction over stock index futures.

Most recently, index participation products (IPs) have been called a market innovation that was stifled by the futures industry and the CFTC. Let us clear this up once and for all. An IP is not some novel form of security and certainly is not used for capital formation. Nor are IPs some form of innovative hybrid. IPs are simply futures contracts which by law must be approved by the CFTC in order to trade.<sup>9</sup>

You should also be aware of the effort the CFTC made to allow IPs to trade. Staff from the CFTC and SEC met on numerous occasions to try to resolve the regulatory issues. The CFTC offered to satisfy concerns raised by the securities industry and the SEC. For example, we proposed permitting securities account executives to be cross-registered as futures associated persons. In response to concerns about futures-style trading systems, the Commission offered to look at a market-maker system along with rules for large order execution of IPs. Unfortunately, the CFTC's overtures were rejected by the SEC.

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<sup>9</sup>As Chairman Breeden has himself acknowledged, issues of statutory interpretation are inherent in any statutory scheme. The definitions of securities and futures are intentionally broad in order to preserve flexibility to address fraud. Indeed, the issue of what constitutes a security has given rise to an enormous amount of litigation for nearly 50 years, far exceeding the relatively few cases concerning futures. Testimony before Subcommittee on Securities of the Senate Banking, Housing and Urban Affairs Committee, March 29, 1990, p. 21.

After the Court of Appeals ruled that IPs are futures, the CFTC contacted the Chairman, President, and Counsel for both the Philadelphia Stock Exchange and the AMEX, and offered to designate IPs on their futures exchange subsidiaries. Once again, the Commission offered to review cross-registration of Account Executives and Associated Persons along with proposed rules for different trading systems. Unfortunately, the securities exchanges chose to pursue their case in court; as a result, IPs, as they were proposed by U.S. securities exchanges, are not currently trading on any exchange.<sup>10</sup>

The litigation fostered by the IPs issue is not the way to deal with intergovernmental regulatory issues. A better model is to work to see if the desires of an exchange to trade a product, as well as the law and regulatory concerns, can be accommodated. In this regard, the Commission has not sought to impose its regulatory authority on any instrument with a bit of futurity. The CFTC has taken action to define its mandate in a pragmatic manner and has taken steps to clarify at which point a product must be regulated as a futures contract. Specifically, our

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<sup>10</sup>Recently, the Toronto Stock Exchange commenced trading on a different product, the Toronto 35 Index Participation Units (TIPs). The specification for these contracts as provided by the Ontario Securities Commission states that these contracts are units of a trust, the Toronto 35 Index Participation Fund created by the exchange. The Toronto Stock Exchange has informed us that it was very careful to structure these units to be deemed to be "securities" for Canadian tax purposes.

jurisdictional exclusion and exemptive rules concerning hybrid products as well as our swaps policy statement reflect this pragmatic approach.

### Shifting Jurisdiction-- The Regulatory Costs

#### Costs to Market Users

Shifting the regulation of stock index futures to the SEC would be very disruptive to the most highly efficient and successful markets in the world. Market users who trade now with confidence and assurance in a familiar market system and under well-settled rules would face a transition period fraught with regulatory uncertainty. How would the SEC regulate these products? What rules would change, be added or be eliminated? This uncertainty will have accompanying costs, as market participants seek more stable trading environments to manage risk. The futures markets would become less liquid and efficient. Ultimately they could shrivel and be replaced by overseas markets which ironically would be perceived as more stable. What the United States does not need at this time is yielding any competitive edge to foreign markets.

Chairman Breeden has stated that stock index futures could be regulated as "securities." This would place futures in a hostile regulatory environment that could undermine the use of

futures as efficient hedging tools and could eliminate legitimate trading practices, like index arbitrage, that now exist. Most importantly, in the case of stock index futures, small regulatory changes would increase the costs of risk management and as a consequence the costs of using the securities market. Such regulation could, for example:

- o hinder routine hedging activities: a portfolio manager hedging in futures who did not want to disclose his existing large cash market position in equities could be accused of trading on inside information and might therefore avoid trading in the futures market;
- o impede liquidity: a long trader in Treasury Bond futures could not liquidate a losing position in a falling market if the "up-tick" rule applied;
- o curtail trading activity: restrictions on the trading of stock index futures and related strategies could be imposed through "side-cars" and order entry collars;
- o lose U.S. business: raising margin levels for futures would inevitably drive business to foreign exchanges whose margins for futures are currently comparable or lower than those in the United States;

- o increase regulatory burdens: different disclosures may be required for different futures products, different trading rules may require reprogramming of systems and staffing changes;
- o increase transaction costs: securities laws do not provide for segregation of customer funds but instead rely on SIPC insurance, which is funded through transaction fees;
- o cause duplicative regulation and registration: state blue-sky laws could apply to contract designations and to market users, and certain firms might have to register as broker-dealers;
- o reduce customer remedies: securities laws afford no reparations forum;
- o reduce enforcement authority: SEC currently does not have power to impose cease and desist orders or civil monetary penalties.

These changes could increase, rather than decrease, stock market volatility while impairing if not crippling the hedging function of stock index and other financial futures. Restricting the use of futures, either directly or by limiting index arbitrage, will impair market liquidity, performance and efficiency. Raising false hopes about reducing volatility

through regulatory proposals that cannot accomplish the goal is bad public policy.

### **Costs to the Exchanges and Clearinghouses**

Stock index, financial and agricultural futures contracts trade side by side on the floors of the same exchanges, by the same traders and under the same rules. All transactions are cleared and settled in the same way. Imposing dual agency regulation on the same exchange with two sets of rules governing the same trading floor and the same members engaged in the same activity would be highly inefficient if not an invitation to regulatory chaos. Two sets of rules for the same exchange clearing houses would also cause similar regulatory overlap or confusion. Moreover, a jurisdictional shift would not obviate--and in fact could increase--the need for continued coordination between the agencies that would exist. Some of the possible consequences of two regulatory systems as they would apply to exchanges and clearing houses are:

- o conflicting floor trading standards and recordkeeping requirements: members of futures exchanges could be subject to different and likely conflicting floor trading standards and recordkeeping requirements for products regulated on the same floor by the CFTC and SEC;

- o duplicative and conflicting audits: exchange compliance staffs could be subject to duplicative and potentially conflicting audits of exchange rule enforcement programs;
- o duplicative and burdensome compliance with rules: futures exchanges could be burdened with having to file duplicative rules with the CFTC and SEC, account for differences in regulatory requirements in those submissions and coordinate approval and implementation;
- o coordinate emergency actions and review: exchange emergency actions of general applicability would have to be coordinated with two regulators who both would review the actions;
- o different standards for trade and clearing records: futures exchanges and their clearinghouses could be subject to two different standards governing the creation of trade and clearing records and exchange maintenance of those processes generally.

#### Costs to the CFTC

As you have stated, Mr. Chairman, overseeing futures trading involves more than "just planting a flag and bringing an occasional enforcement case." It requires the long-term,

dedicated effort of an experienced professional staff, which I am proud to say we have at the CFTC. Our team of economists, lawyers, accountants and futures trading specialists is as highly competent and motivated as any group with whom I have ever been associated. Like the industry that they help regulate, their expertise is highly specialized and cuts across all commodity groups. Splitting off stock index or financial futures from the CFTC's jurisdiction could result in a loss of experienced CFTC personnel, which would devastate agency morale and harm the effective oversight of the other futures markets that remain within our jurisdiction. And as with any championship team, there are certain players who are the franchise, who help to train the rookies and without whom the team loses its identity. That is certainly true at the CFTC where we are fortunate to have a critical mass of experienced personnel whose departure would decimate the agency.

It would be no easy task to replace these people. It is difficult enough to lure top personnel into Government service. This Committee is well aware of this problem since in S. 1729 it has authorized the Commission to establish a pay system comparable with other federal financial market regulators to help us recruit and retain personnel. Passage of this bill would be an empty gesture, however, if we could not assure our candidates that the jurisdictional wars were over and there was not another hostile takeover in the wings.

### What Price Merger?

It has been said that a merger will mean an end to agency disputes and can be accomplished leaving existing regulatory systems intact. But if futures are not to be regulated as securities and no other policy changes are intended, then what is to be gained by a merger? Moreover, even assuming no changes in regulatory policy, a merger poses other problems. For example, innovation that represented a competitive threat to existing securities products might not see the light of day. As Chairman Greenspan observed in discussing such dramatic changes as merger:

these solutions [merger, shifting jurisdiction] would concentrate a great deal of regulatory authority over the financial system in a single agency and this has been a concern of Congress for a long time. In addition to the potential management difficulties of a larger organization, there is the risk that bureaucratic inertia in a larger agency could be an impediment to the process of innovation. We should not lose sight of the fact that under the existing system of split jurisdiction over financial instruments, our financial markets have been the most innovative in the world, with many of the new products spurred by the introduction of index futures and other futures.<sup>11</sup>

Ironically, a single super agency may not mean regulatory peace in our time. Persons acting in good faith from either the same or different agencies can of course cooperate and coordinate regulatory programs. But a single agency does not guarantee this result. A super agency representing conflicting market interests

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<sup>11</sup>Statement by Chairman Alan Greenspan before the Securities Subcommittee of the Senate Banking, Housing and Urban Affairs Committee, March 29, 1990: 11.

will have a variety of divisions vying for power and authority. The contest for power may not vanish, but it could become intramural, paralyzing the decision-making process. Moreover, to the extent the disagreements are concealed from public view, they may become even more intense and divisive. And in any such struggles the cards would be stacked against the smaller CFTC. Furthermore, unless the law is significantly changed, third parties can still sue over specific product characterizations regardless of whether there are one or two agencies.

Merger would likely mean that the regulation of some futures products -- agricultural, energy and other physical commodities -- would suffer neglect at best. At the CFTC, futures are our most important product. This is true regardless of the commodity involved. We doubt this would hold true at a super agency whose budgetary and policy priorities would center upon regulating capital formation and the securities markets. Futures regulation of tangible commodities would likely become a regulatory stepchild in such an environment. Effective oversight and attention to futures trading could soon disappear if the CFTC were submerged in a super agency, most of whose personnel would know little about the highly specialized nature of futures contracts and the unique economic functions they perform.

In fact, one merger proposal already has relegated futures regulation of agricultural and other physical commodities to a

"division" within a new super agency. This is reminiscent of the days when the old Commodity Exchange Authority was a tiny component within USDA and regulated agricultural futures trading from the basement of the Chicago Board of Trade building (which often flooded!). But the public interest in properly functioning futures markets requires more than a return to the 1930s and a regulatory framework that Congress wisely abandoned. In creating the CFTC, this Committee recognized that the regulation of all commodity futures traded is important and will inevitably suffer if placed within a larger establishment with different, indeed conflicting, priorities and traditions. As the Committee reported in 1974 at the time it approved creation of an independent CFTC with exclusive jurisdiction to regulate futures trading in all commodities:

{W}hile in the past the Commodity Exchange Authority of the USDA has been authorized to regulate only certain agricultural commodities that are produced in the United States, the Committee felt that agricultural products not produced in this country and commodities such as silver and copper, which have no relation to agriculture, could not be effectively regulated within the Department of Agriculture or an agency dominated by the Department of Agriculture. (S. Rep. No. 93-1131 at 21)

What argument would now lead us to believe that an agency mainly concerned with the cash securities market and with no relation to agriculture, silver, copper or energy products could effectively regulate futures contracts based on those underlying cash markets?

### Conclusion

Throughout history vested interests have sought government help to thwart competitive threats fostered by innovation. That, I submit, is what is currently going on in the debate over stock index futures. It is no secret that traditional Wall Street brokerage and exchange interests are enjoying less than boom times. Making futures the fall guy may hamper or remove a competitive irritation for these traditional interests. But they will not address the problems that arose in October 1987 and October 1989. Nor will they contribute to the performance of our markets.

The case has not been made to disturb the existing jurisdictional assignment between the CFTC and the SEC. Any such change would have severe regulatory costs both for the markets and their customers. Congress should not tear apart a regulatory framework that has produced successful, competitive futures markets -- certainly not on the basis of unsubstantiated arguments. Quick fixes that do not address real problems will only create greater problems in the future.

Federal securities and futures laws have been and are flexible enough to accommodate change. To the extent that market innovation suggests further regulatory flexibility is needed, it can be accomplished within the current framework. A structural

overhaul is not required. The existing regulatory structure works and can continue to work if the agencies cooperate in good faith.