NASD

Testimony of Joseph Hardiman
President
National Association of Securities Dealers

Before a Hearing of the

Committee on Banking, Housing, and Urban Affairs
United States Senate

Concerning

The Capital Markets Competition, Stability, and Fairness Act of 1990

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I am Joseph Hardiman, President of the National Association of Securities Dealers, Inc. (NASD). I am pleased to have this opportunity to appear before you today to discuss the issues involving the Administration's legislative proposal, "The Capital Markets Competition, Stability, and Fairness Act of 1990", and to underline our strong support for this needed legislation.

The NASD supports this initiative in its capacity as a national securities association registered with the Securities and Exchange Commission (SEC) under the Securities Exchange Act of 1934, and as a member of the Ad Hoc Coalition for Intermarket Coordination. The Ad Hoc Coalition is composed of most of the securities self regulatory and clearing organizations. Although we are in many respects business competitors, we have joined together to address the problems of fragmented regulation of the markets for stocks, stock options and stock index futures, and of barriers to innovation and competition in these markets.

Unlike other members of your panel today, the NASD does not have any direct beneficial interest from the reforms contained in the Administration's proposal. The markets that we regulate and operate do not have indices on which there are futures or options contracts; we have not introduced products that have been rejected by the courts on jurisdictional grounds; and we do not have, nor do we espouse, circuit breakers that kick in at predetermined levels of market volatility. We do, however, oversee the trading of securities of a large number of rapidly growing companies whose timely access to capital at competitive costs and whose dependence on individual investors is closely tied to stability and confidence in the nation's capital markets. We support the Administration's proposal because it is good public policy: it would promote the safety and soundness of the securities markets, which are one of our nation's strongest assets; it would solve problems that result from fragmented regulation; it would help promote stability in the equity markets; and it would be a positive step toward restoring confidence of investors in our securities markets.

The NASD has not come by these views only recently. In March 1988, based on our review of the problems posed by the 1987 market break and the studies that resulted from that unsettling event, the NASD put forward several recommendations, which we have since reiterated a number of times in letters and testimony to both the House and Senate. Those recommendations called for:

- Regulatory authority for equity and equity derivative instruments to be vested in a single agency at the federal level (namely the SEC)

- Relative margin levels for equity and equity derivative instruments to be made consistent across all marketplaces; and

- Clearing, settlement, and payment systems to be coordinated across marketplaces to reduce financial risks for all market participants.

Your invitation to testify today asked the major questions that must be considered in your review of this legislation:

- Is there a need for one regulator of stock and stock derivative instruments?
- Which federal agency is appropriate to regulate stock index futures?
- To what extent, if any, does the current system of margin regulation for stock, stock options, and stock index futures contribute risk to the financial system?
- Should there be federal regulation or oversight of stock index futures margin?
- Comment on the need to modify the exclusivity clause of the Commodity Exchange Act to allow instruments with both futures and securities characteristics to trade concurrently on securities exchanges and commodity markets.

The NASD

The NASD is the only entity registered with the Securities and Exchange Commission as a national securities association under the Securities Exchange Act of 1934. It is charged with the responsibility of regulating both the National Association of Securities Dealers Automated Quotation (NASDAQ) market, which is the second largest securities market in the United States and one of the five largest in the world, and the over-the-counter securities markets. This task encompasses both regulation of NASD member firms and the individuals associated with those members.

The NASD has 5,982 broker-dealer members employing 429,000 registered sales persons and principals. Some 4,900 securities issued by 4,200 companies are quoted in the NASDAQ market and 439 NASD members serve as market makers in those securities. The scope of the NASD's regulatory jurisdiction extends to all such members and their associated persons.

The NASDAQ stock market is a highly visible screen-based market with intense competition between market makers. Their bid and offer quotations are continuously displayed over thousands of subscriber terminals, with real-time transaction reports for all NASDAQ/National Market System stocks. Ownership and participation by investors in the NASDAQ market is broad and diverse. Individual investors own approximately two-thirds of the market value of NASDAQ stocks. Institutional investors are also very active in NASDAQ -- and are becoming a growing part of our market -- but individual participation is paramount, thus the NASD is concerned with the perceptions of individual investors about today's markets. Investor protection is the cornerstone of the NASD's regulatory and enforcement efforts.

The Capital Markets Competition, Stability, and Fairness Act of 1990

The Administration's proposed legislation comprises three major provisions:

- Shift regulatory authority for stock index futures to the SEC in a manner that minimizes the disruption to the current operation of the markets in these instruments.
- Provide the SEC with oversight authority over the futures exchanges' ability to set margins, similar to its current oversight authority over margin setting by the securities and options exchanges.
- Modify the "exclusivity clause" of the Commodity Exchange Act to end pointless litigation and remove barriers to innovation that are driving new products to foreign markets.

Issues Confronting the Securities Markets

The market breaks of October 1987 and 1989 confirmed that the markets for stock and stock derivatives constitute, in economic terms, a single market. This interrelationship, documented in the Brady Commission report on the 1987 market break, has been accepted by the overwhelming majority of scholars, investors, regulators and others who have studied the issue. Logically it follows that these markets should be regulated in a consistent and coordinated manner that will minimize the likelihood of major market disruptions that negatively impact investor confidence and capital formation.

Markets are not attracting individual investors as they used to, partly because of the efficiency of investing through institutions, and partly from the uncertainties surrounding the markets. While the NASDAQ market has strong representation by individual investors, it is a matter of some concern to us that the percentage of publicly traded stocks outstanding held by individuals declined from 84% in 1965 to 55% in 1989.

This decline in individual investor confidence and participation is reflected in the decline in Initial Public Offerings (IPOs). After peaking at $18 billion in 1986, IPOs raised only $6 billion in each of 1988 and 1989, further reflecting investor unease after the 1987 market break, and slowing equity capital formation.

For the first time since the October 1987 market break, the NASDAQ market experienced in the second quarter of 1990 a slight upturning in individual investor interest in the markets and the amount of equity capital raised through IPOs. It would be a severe setback to the market and the economy if we were to experience another major market disruption because of an inability or failure to coordinate key intermarket mechanisms.

Stock Index Futures Jurisdiction

By way of preface, I do not believe this issue should be viewed as a "turf" battle between the Chicago commodities markets and the CFTC on one hand, and the New York securities markets and the SEC on the other, as some have suggested. The SEC regulates large securities and options markets located in Chicago, and the CFTC has oversight over several futures exchanges in New York, and no one suggests that either of them exhibits a bias due to location of the exchanges they regulate. Furthermore, if this legislation is adopted, there will be no shift of index futures contracts away from the markets in which they now trade. The proposed legislation is about something much more important -- restoring investor confidence in the nation's capital markets.

The NASD, both as one of the largest regulators of the securities markets, and as an operator of a market with a large share of individual investor participation, sees this provision as the key part of the Administration's proposal in helping to restore investor confidence in the markets. The current scheme of split regulation of stocks and stock index futures contracts leads directly and inevitably to hobbled intermarket enforcement, thereby impacting investor confidence in the markets for both products. The reason this split approach hobbles enforcement is simple: With two regulators each covering only their half of one market, there is no practical, comprehensive and continuing means to detect and thus prevent fraud in transactions between those two parts of the market.

Securities exchanges under SEC oversight have advanced automated systems that provide trade-by-trade information on a consolidated tape and audit trails with time of execution. The futures markets, on the other hand, do not have this information, which often impairs intermarket fraud investigations. Unifying jurisdiction over stocks, stock options and stock index futures in the SEC will significantly enhance the ability to promptly obtain and rationalize the information needed for intermarket investigations, and thus strengthen efforts to prevent fraud.

Bifurcated regulation under the SEC and CFTC makes it more difficult and time consuming for securities and futures exchanges to work out information sharing issues than working out those issues between stock and options exchanges, which are regulated by the SEC. For example, it took the New York Stock Exchange and the Chicago Mercantile Exchange some seven years after the S&P 500 futures contract was established to come up with initially acceptable front running prohibitions. On the other hand, securities and options exchanges, both of which are regulated by one regulator, the SEC, worked out such prohibitions a decade ago.

Separation of regulatory authority also impairs obtaining cooperative agreements with foreign regulatory authorities, since such agreements on behalf of the United States must be negotiated separately, or in stages, with both the SEC and the CFTC, which results in a process that is certainly more expensive and time consuming, and often less effective.

Transfer of jurisdiction would not weaken CFTC regulation over other commodities. Stock index futures are only 5% of all futures trading, and are the only one of the 20 largest futures contracts (as measured by contract volume) that is based on a stock index. Moving this responsibility to the SEC would allow the CFTC to concentrate its resources on the other financial and physical commodities futures, which account for the overwhelming percentage of activity in the markets it is charged with regulating.

Transfer of jurisdiction will also not be the "opening wedge" for the SEC to pick up all of futures regulation. Stock index futures, unlike the markets for physical commodities, have a significant underlying cash market, and represent a relatively large part of the derivative market as compared with the cash market. When coupled with the close interrelationship of these markets, these factors make stock index futures the core of the problem in the securities markets, and thus the only jurisdictional shift that the Administration's proposal contemplates.

The NASD recommends the transfer of jurisdiction over stock index futures to the SEC because it has the broadest expertise in regulating stock and stock derivative markets, has been charged by Congress since 1934 to assure that those markets not only operate in a fair and orderly manner but also importantly for the protection of investors, and has carried out that responsibility efficiently. Indeed, in our judgement, the investing public will be reassured to know that at all times, but particularly in times of market stress, there is one agency at the federal level charged with overseeing all aspects of the "single market" for stocks, stock options, and stock index futures.

<u>Margin Regulation for Stock, Options, and Stock Index Futures</u>

A key area of concern for the NASD and others interested in the stability of the securities market is the appropriate level of margins for stocks, stock options and stock index futures and the need for a coordinated approach to the establishment of such margins. This does not imply equality of margins but rather the need for consistency in the application of the standards used to determine appropriate margin levels whether they be for determining the amount of leverage that can be used to acquire control of financial assets or for prudential purposes to protect the financial integrity of market participants. While there is federal oversight of margins in the stocks and stock options markets, there is virtually none in the stock index futures markets. In the absence of such oversight, there is no way to harmonize margins between these instruments to protect the public's interest.

In terms of leverage, the fact is that futures professionals and institutions can control such a large amount of stocks with so little money that relatively small amounts of capital can potentially place significant selling pressure on the underlying stock market, with the result being a major market disruption.

For example, before the October 1989 break, a futures trader with $50,000 could control $2 million in stock, ten times more than the securities trader because of the widely differing margin requirements between markets. Even though margins were raised by the futures exchanges after the 1987 break, they were actually dropped by those exchanges to lower levels in October 1989 than they were before the 1987 break, and were at 2 to 3% on October 13 and 16, 1989. During these market breaks, when the need for liquidity is the greatest, futures exchanges drain liquidity through margin calls and increased rates, just the opposite of what should be occurring. As Alan Greenspan, Chairman of the Federal Reserve Board, testified before the House Subcommittee on Telecommunications and Finance on May 24:

> Although no futures clearing house has ever suffered a loss from a default on a stock index futures contract, certain actions by futures exchanges and their clearing houses in recent years raise questions about the adequacy of futures margins from a public policy perspective. Specifically, we have concerns about the tendency for these organizations to lower margins on stock index futures to such a degree in periods of price stability that they feel compelled to raise them during periods of extraordinary price volatility. While such a practice has heretofore protected the financial interests of the clearing houses and their members, it tends to compound already substantial liquidity pressures on their customers, on lenders to their customers, and on other payment and clearing systems. In the Board's view, somewhat higher margin levels on stock index futures would obviate the need to raise them in a crisis and thereby reduce concerns about the reliability of our market mechanisms, especially clearing and payment systems, in times of adversity.

The NASD shares the view of the Federal Reserve Board, the Department of Treasury, and the SEC that federal oversight is appropriate to ensure that margins on stocks, stock options and stock index futures are established at levels that are adequate under a wide range of market conditions. To achieve this needed consistency, we further believe that this oversight should be vested in the one federal agency that already has this authority for two of the three interrelated products involved -- the SEC.

Consolidating margin oversight responsibilities in the SEC will also facilitate cross margining, advocated by the Brady Commission, and the White House Working Group. Cross margining allows options and futures clearing houses to share position information for common clearing members and to calculate an overall margin requirement based on their combined positions. By avoiding over-collateralization of intermarket hedge positions at the clearing houses and thus for firms and market makers, it rationalizes credit requirements at prudential levels and sustains or increases market liquidity. Cross margining has the especially desirable result of decreasing the risk to the clearance and settlement systems in times of stress.

A more detailed analysis of the margin issue and the desirability of cross margining will be provided by Wayne Luthringshausen in his testimony on behalf of the Coalition.

Modification of the Exclusivity Clause of the Commodity Exchange Act

The NASD supports the provision of the Administration's proposal to modify the exclusivity clause to allow instruments with both futures and securities characteristics to trade on both the securities and futures exchanges, and sees it as crucial if we are not to abandon such useful hybrid products to our competitors overseas. Because it is the American and Philadelphia Stock Exchanges Index Participations (IPs) that joined the issue on the exclusivity clause of the Commodity Exchange Act, James Jones, Chairman of the American Stock Exchange, will treat this issue in detail in his testimony.

While fragmented regulation may spur innovation, it can also cause jurisdictional quarrels that can stifle innovation and competition. This is precisely the situation with the development of IPs, the ensuing litigation that denied the securities markets the right to trade the product under the securities laws, and its subsequent shift to foreign markets. In that case, the Seventh Circuit Court of Appeals determined that any financial instrument with any degree of "futurity" must be traded on a futures exchange under the exclusivity clause of the Commodity Exchange Act. Since all new securities products have some element of futurity, this opinion has far reaching consequences for the competitiveness of our nation's securities markets in today's global environment.

As a final comment on innovation in the financial markets, we often hear that the futures markets are more innovative than the securities markets. This is simply inaccurate. The SEC has approved new product proposals since the 1970's that have included such derivative products as options on stock indexes, Treasury bonds, bills and notes, Government National Mortgage Association instruments, debt indexes, and foreign currencies. Moreover, under the securities laws and the SEC's watchful eye to assure compliance with disclosure and anti-fraud standards, issuers and their investment bankers have come up with approximately 30 different new securities in the past ten years, with a total trading volume well in excess of hundreds of billions of dollars. The securities markets, their participants, and the SEC are not less innovative, and they should be freed from the strictures of the exclusivity clause to allow even more of the innovation needed to remain competitive both domestically and internationally.

Conclusion

The NASD supports the Administration's proposed Capital Markets Competition, Stability, and Fairness Act of 1990 because it is good public policy: it would promote the safety and soundness of the securities markets, which are one of our nation's strongest assets; it would solve problems that result from fragmented regulation; it would help promote stability in the equity markets; and it would be a positive step toward restoring confidence of investors in our securities markets.

After the market break of 1987, the reforms contained in this legislation were identified as necessary. Three years -- and several market events -- later, these reforms are still waiting, market instability is still present, and individual investors have yet to return to the markets in significant numbers. We urge the Congress to listen to the warnings the market has been giving us in those past three years, and to pass this critical legislation now.

Thank you for your attention, and I would be happy to answer any questions you may have.