MEMORANDUM

TO: Senator Donald W. Riegle, Jr.

FROM: Steven B. Harris

DATE: March 13, 1987

SUBJECT: Boca Raton Panel Discussion, March 21, 1987
Futures Industry Association Conference

You are not on the panel -- but brief material appl

You will be speaking with a panel of Senators, (D'Amato, Harkin, and Shelby), moderated by Leo Melamed, Chairman of the Executive Committee of the Chicago Mercantile Exchange ("CME").

According the CME, the Senate Banking Committee may place a greater role over the futures industry this year than ever before. Key concerns of the futures industry, and particularly the Chicago Mercantile Exchange, include: exchange rate provisions as part of the trade bill; hearings and potential legislation concerning futures and options trading on stock indexes and their impact on the underlying equity markets; the expansion of banks into the equivalent of an electronic unregulated exchange (Security Pacific proposal); off-exchange futures transactions dealing with the "Treasury Amendment"; and efforts to legislate on insider trading. All of these are within the jurisdiction of the Senate Banking Committee.

Exchange Rates

The CME is the leading forum for the trading of futures and options on international currencies. Trade bills in both the House and Senate incorporate provisions calling for the creation of a mandatory strategic currency reserve, mandatory negotiations to reform the international monetary system at a reconvened Bretton Woods, and mandatory intervention in the markets by the U.S. government. The CME is adamantly opposed to S. 30 by Senator Moynihan, the most strident of such proposals, but likely could live with a version closer to the Heinz bill passed by the Senate Banking Committee in the last Congress.

Leo Melamed is a very close friend and admirer of Milton Friedman, and a co-founder with him of the American Coalition for Flexible Exchange Rates (ACFX) (background attached). Melamed is interested in testifying on exchange rates when the International Finance Subcommittee (Sarbanes) holds hearings later this month or early in April. You are not a member of the Subcommittee.

Program Trading/Stock Index Contracts

The S&P 500 is the most actively traded stock index contract in the world, and it is traded on the CME. The Chicago Board of Trade, New York Futures Exchange, and Kansas City Board of Trade all have index contracts. The exchanges are concerned that "program trading" and "triple-witching" have entered the political and journalistic lexicon to provide a shorthand term to deride futures and options markets. The exchanges believe the following misconceptions exist and look forward to the opportunity to debunk them in congressional hearings.

Misconceptions:

-- index futures and options adversely and dramatically accelerate price volatility in the equity marketplace;

-- this erratic price volatility compromises market integrity and jeopardizes small investor confidence in the capital markets;

-- current price volatility has no relationship to traditional fundamental evaluations of stock values;

-- the "triple-witching" problem is not only a quarterly event, but rather a heightened manifestation of potential frequent massive price movements artificially caused by the program trading phenomenon.

Dingell has expressed considerable concern along these lines and has announced hearings.

The exchanges present arguments that their markets have provided extraordinary new opportunities for managing risk, allowing pension funds, university endowments, mutual funds, and all forms of portfolio managers to lay off market risk and concentrate on outperforming the market; have facilitated new capital issues that have risen at historically high levels paralleling the introduction of index futures in 1982, and point to the fact that U.S. equity market volatility is no greater than the Tokyo and London Stock Exchanges despite the fact those exchanges do not have well-developed stock index futures.

The Securities Subcommittee will be holding hearings on SEC Authorizations; Internationalization of the Capital Markets; and Insider Trading this year, so don't volunteer hearings on this subject anytime in the immediate future. We are thinking about it however.

## Security Pacific

The bank holding company, Security Pacific, has applied to both the SEC and the Federal Reserve Board for permission to provide brokerage, clearance, and margin services through an electronic over-the-counter options trading system on government debt instruments. Both the CME and the Chicago Board of Trade [with its Treasury bond contract] vigorously oppose this request, arguing that this proposal would allow Security Pacific to operate as an exchange, without any of the regulatory safeguards, costs, and capital requirements which apply to exchanges currently operating under the Commodity Exchange Act.

You should be highly sympathetic to this position and indicate you will monitor the situation closely but don't make any definitive commitments.

## Off-Exchange Futures Transactions: the Treasury Amendment

Recently, a number of individually tailored debt instruments have been crafted to pet their redemption value to various indexes such as the S&P 500 or the New York Merc oil futures contract. These are viewed by exchanges as the equivalent of trading futures off the exchange, which under the Commodity Exchange Act would be lawful. The Commodity Futures Trading Commission is now receiving these offerings, because its permissibility is unclear. The "Treasury Amendment" in the Commodity Exchange Act was specifically provided to insure that the interbank market in forward contracts in currencies was not disrupted, or deemed an "off-exchange futures transaction," thus unlawful. However, the Treasury amendment exception is being stretched by innovations from Solomon Brothers, Goldman Sachs, et al. The exchanges are uncertain as to the implications of this on their markets. Perhaps it is adverse to their markets, because it allows trading in futures that would otherwise go through their markets. Perhaps it is helpful because it requires greater hedging on those markets by those that issue and hold these instruments.

Esoteric issue which you should be aware of -- but adopt a wait and see attitude.

## Insider Trading Implications

The exchanges are concerned that the insider trading problems of Wall Street will spill over and lead to some unforeseen and unnecessary action affecting the futures markets, such as proposals to give the Federal Reserve Board margin authority over futures or amend the SEC '34 Act to ban dual trading.