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TESTIMONY OF

DR. WENDY L. GRAMM

CHAIRMAN

COMMODITY FUTURES TRADING COMMISSION

BEFORE THE

COMMITTEE ON AGRICULTURE

UNITED STATES HOUSE OF REPRESENTATIVES

JUNE 14, 1988

Mr. Chairman and Members of the Committee:

The Working Group on Financial Markets was established by Executive Order on March 18, 1988, to cooperatively address the complex issues involved in the market break in October of 1987. For two months the Working Group, composed of Chairman Greenspan of the Federal Reserve Board, Chairman Ruder of the Securities and Exchange Commission, Undersecretary Gould of the Treasury Department (designated by the Secretary of the Treasury) and I analyzed these issues and reviewed the numerous recommendations made in the wake of last October's market decline. The Working Group identified as its primary mission addressing the major uncertainties in the financial system which pose the risk of disruptions in that system, and focused on specific actions that could be taken now and in the near term to substantially lessen these risks.

On May 16, 1988, we presented our report to the President. The Working Group Report indicates that steps can and have been taken, and agreement can be reached to address complex intermarket issues within the context of a continuing Working Group dialogue and continuing intermarket discussions at the exchange level. Moreover, this process indicates that effective changes can be implemented without the existence of a more formal structure on top of existing regulatory and self-regulatory arrangements.

Accomplishments of the Working Group

The Working Group reached agreement and made recommendations in a number of critical areas, including:

- an unprecedented agreement on coordinated circuit breakers in the cash and derivative markets to allow for cooling-off periods during times of high market volatility;
- agreement that current margins in equities and futures markets are adequate for prudential purposes; that minimum margin for prudential purposes for an individual stock should be significantly higher than that required for a stock index futures contract;
- agreement on recommendations for the credit,

clearing, and payment systems to ensure even greater coordination among markets and to avoid systems gridlock; and

- agreement on contingency planning, including agreement that the Working Group continue to meet in order to ensure continuing coordination and a forum for consultation in the event of future market disruptions.

The Commodity Futures Trading Commission (CFTC or Commission) concurs in these findings and recommendations.

Coordinated Trading Halts and Reopenings

Perhaps most significantly, the Working Group recommended action to avoid *ad hoc* disruptions of the market by recommending a "circuit breaker" mechanism which would operate across all markets. The circuit breaker would use pre-established limits that are broad enough to avoid being tripped except on rare occasions, but narrow enough to permit the payment and credit systems to keep pace with extraordinarily large market moves. In broad outline the Working Group recommended that all U.S. markets for equity and equity-related products -- stocks, individual stock options, and stock index options and futures -- halt trading for one hour if the Dow Jones Industrial Average (DJIA) declines 250 points from its previous day's closing level. The markets then would reopen under procedures designed to highlight order imbalances before actual trading begins. A second closing, this time for two hours, and reopening will occur if the DJIA declines 400 points below its previous day's closing level.

In addressing market reopening procedures, which are as important as closings, the Working Group recommended that the New York Stock Exchange model these procedures after those used on so-called Expiration Fridays. These special procedures were arrived at through the cooperative efforts of the securities and futures markets and their regulators to address third Friday volatility. They would enhance the information made public about market conditions and order imbalances, thereby facilitating the making of buy or sell decisions during volatile periods.

Members of the Working Group consulted with the self-regulatory organizations ("SROs"), as well as with knowledgeable industry participants, about the design of these procedures. In particular, I worked with the futures SROs that offer equity index products. The SROs agreed to alter previous circuit breakers installed unilaterally during the market crisis. With the Working Group as a whole, I strongly believe that these recommendations can be implemented most effectively and expeditiously by SRO-initiated rule changes, subject to appropriate notice, comment and agency review.

Analysis of Prudential Margins

The Working Group studied existing margin systems and requirements, focusing on how well these systems operate to insulate the markets from default and on exemptions in the stock, futures, and options markets for particular classes of traders or trades. A number of important conclusions were reached as to the appropriate level of margins for the prudential purpose of protecting the integrity of the financial system and as to the consistency or harmony between margins on individual stocks and those on stock index futures and other equity derivative products.

Based upon extensive analysis of the historical movement of prices for individual stocks, stock indices, and stock index futures, as well as settlement practices in the stock and futures markets, the Working Group calculated the margin levels sufficient to cover price movements with varying degrees of confidence (*i.e.*, 90%, 95%, 99% of the time.) This analysis, in which all Working Group members concurred, revealed that current levels of margin are more than adequate for the prudential purpose of protecting broker-dealers, futures commission merchants, and clearing corporations from investor and trader defaults on their margin obligations.

The adequacy of futures margin levels can be judged by examining the risk of exceeding a given margin level over relevant past periods. Based on data from the period January 1986 to April 1988, margins of slightly more than 5% of contract value in the futures market would have protected against 99% of observed price changes. Based on data for the post-October period, November 1987 through April 1988, that same 99% likelihood of price change coverage would require margins slightly less than 8% of contract value.

On October 16, 1987, maintenance margin required by the Chicago Mercantile Exchange on its S&P 500 futures contract was $7,500, representing approximately 5% of contract value on the close that day. Currently, S&P 500 futures maintenance margin is $10,000, representing approximately 8% of the contract's value at the close of May 13. Thus, maintenance margins were and currently are adequate to cover 99% of observed price changes. Initial margins were and continue to be set at significantly higher levels than maintenance margins.

Members of the Working Group concluded that margin levels sufficient to provide protection against all possible price movements (as opposed to 95% or 99% of all price movements) would impose unacceptable costs on market participants and could reduce the liquidity and efficiency of markets. For extreme price movements, other mechanisms, such as capital requirements, clearing-fund guarantee deposits, and intra-day variation margin payments, are in place to protect the system against defaults. These additional mechanisms worked well during the week of October 19. In addition, implementation of the Working Group's recommendations on a circuit-breaker mechanism and improvements and clarification as to responsibilities in the credit, clearing, and settlement systems should add significant protections against financial system risks from extreme price movements.

The Working Group's technical analysis, performed by agency staff members, demonstrated that a consistent and harmonious margin regime across markets requires a significantly higher prudential margin level for individual stocks than for stock index futures. This conclusion follows from two facts: stock indexes have a smaller percentage price variability than do individual stocks; and the settlement or grace period in the futures market is markedly shorter than the period for stocks.

The degree of harmonization of individual security and stock index futures margins can be judged, for example, by comparing the margins required to prudentially protect against the price changes of 80% of the individual stocks in a representative index, such as the Institutional Index, with the margin required for the S&P 500 futures contract over a meaningful period such as

January 1986 through April 1988. The margin level required to protect against 99% of the price changes in 80% of the stocks comprising the Institutional Index, given a five-day collection period for margin calls and settlement, was slightly more than 17%. The margin necessary to protect against stock-index futures price changes, given their one-day period of collection for margin calls and settlement, was slightly more than 5%. Based on this example, then, the margin on individual stocks should be roughly three and a half times the margin on stock index futures for consistency. The multiple would be somewhat less if three-day settlement were the practice in the cash market.

The Working Group's analysis of prudential margins makes it quite clear that consistent margins will vary significantly across markets without conferring any special competitive advantage on one market or disadvantage on another.

Margins and Volatility

As reported in the Working Group's Interim Report, the Treasury, Chairman Greenspan, and I do not believe that the evidence supports the conclusion that higher margins will reduce volatility. In fact, it is our belief that higher margins will raise transaction costs and have a negative effect on market liquidity and efficiency, thus, possibly increasing rather than reducing volatility. Increasing margins also risks moving futures trading into off-shore markets.

The CFTC concurs in the view that raising margins beyond prudential levels would have the effect of increasing transaction costs, with severe risks to the efficiency and competitiveness of the U.S. financial system that would likely outweigh any benefits. However, markedly increasing margins above prudential levels would not meaningfully improve the market's financial integrity or provide additional protections to market users. Thus increasing margins would increase costs while providing no additional benefits in return. Moreover, higher margins could reduce participation in the futures markets by some market participants, and, hence, adversely affect liquidity in the markets.

The higher costs imposed by increased margins may cause the market to shift to another location not subject to those costs and not subject to U.S. regulatory systems. Once the advantages of liquidity are lost, such advantages may not be regained by removing those impediments. The risk of losing a market to an off-shore location is dramatically more likely for a limited number of cash-settled derivative products than for stocks themselves, whose primary market is likely to remain domestic.

The Commission sees no evidence that the level of margins for stock index futures had any significant impact on the rise of stock prices during the recent bull market nor on the collapse of stock prices in October 1987. Futures margins did not encourage significant speculative participation in securities prices because the stock index futures market historically has consisted largely of institutional rather than speculative traders. Since these institutional futures traders generally are unleveraged, and as their futures trading represents an extension of their stock market trading and strategies, their activities in futures should not have an independent effect on stock price levels. In addition, during the price break on October 19, only a minority of traders were speculators -- including local traders -- and these traders tended to be a stabilizing influence since they were net buyers of stock index futures.

Margin Setting Authority and Federal Oversight

The members of the Working Group unanimously supported the view that the primary responsibility for setting margins in all markets should be with the SROs, which have the closer proximity to timely trading information and economic stake to perform this role most effectively. There was disagreement, however, about the appropriate scope and form of federal oversight of margin setting.

The CFTC believes that the current approach to setting margins on futures -- authority to set margins on a day-to-day basis resting with the SROs, with emergency authority residing in the CFTC -- is entirely appropriate. This view is based on the functioning of the "pay as you go," daily mark-to-market system of futures margins, on the strong incentive for firms to protect their capital, and on a historical record of success: No customer funds were lost in October in a clearing member default. The CFTC's emergency power is supplemented in more normal circumstances by its moral suasion. For example, the CFTC recommended in the Financial Follow-up Report that stock index futures margins be reviewed to determine whether they provided an adequate cushion for aberrant price moves and concentrated positions. The exchanges reviewed their margins and increased them.

Improving the Intermarket Coordination of Clearing and Settlement Systems

The Working Group analyzed and made a number of recommendations concerning actions that could be taken to reduce uncertainty, increase coordination, assure confidence in the integrity of such systems, and facilitate their smooth operation in volatile markets. These actions go a long way toward coordinating the clearing and settlement process, can be undertaken in the short term and can be accomplished without legislation.

It is important to note that the current system of multiple, independent clearing organizations performed well during the market break, and continues to provide important diversification to our financial system. Under this system of separate clearing organizations, risk is compartmentalized. It is possible that one clearing organization could experience operational problems without such problems spreading to other clearing organizations or having a critical impact on other parts of the market. In addition, the existence of multiple clearing organizations has, over the years, resulted in innovative methods of clearing trades and state-of-the-art technological improvements, while keeping clearing costs at a competitive level.

The CFTC agrees with the Working Group that the securities, futures and banking industries should explore and pursue initiatives to ease potential system stresses by further reducing the size of payment obligations. These initiatives, for example, should include pilot programs in cross-margining. The Group believes, and the CFTC agrees, that by undertaking the recommended specific actions and then evaluating the results, we can better determine the necessity for, and the relative costs and benefits of, more profound structural changes to securities and derivative markets clearing and settlement systems.

Continuing Coordination

The CFTC believes that continuation of the Working Group, as it is currently composed, is the most appropriate way to continue the process of addressing intermarket issues. The existence of the Working Group also facilitates and enhances our contingency planning efforts.

Much has been accomplished in a short period, but work on a number of issues has not been completed. While we agree with the recommendations of the Brady Commission and others that there should be some regulatory mechanism to resolve continuing intermarket issues, we believe cooperative efforts under the existing regulatory structure will be more effective and less disruptive than a more formal, legislated structure. Indeed, major regulatory restructuring at this time -- and the uncertainty which could ensue -- would distract attention from the critical, substantive issues that need to be addressed first.

The Working Group has established a cooperative framework in which regulators, self-regulatory organizations, and market participants can work together to resolve intermarket issues.

Importantly, the Group has proved that consensus on significant reforms can be achieved under its aegis and already has made demonstrable progress on the issues deemed most critical to the market's smooth functioning and investor confidence. These efforts provide a common ground for future efforts. Equally important, the Working Group has created a process for further interagency cooperation on such intermarket issues as clearing and settlement, contingency planning, monitoring implementation of its recommendations, and resolving the remaining issues.

Actions by the CFTC and the SROs Since October 1987

Since the October market break, the CFTC has completed four major studies of futures activity during October 1987 (previously submitted to this Committee), made recommendations to futures SROs concerning program enhancements to strengthen protections in volatile markets, monitored SRO progress in responding to CFTC recommendations, initiated improvements in its own data collection processes and data bases, coordinated and consulted with other Federal regulatory agencies in addressing contingency planning and other post-market break responses, and communicated with foreign regulators to promote information-sharing and cross-border financial surveillance.

Following the market break the Commission initiated efforts to improve its data systems to provide more complete and timely data for analysis in the event of continued volatility in the stock market and to enhance its financial surveillance data base. With respect to the CFTC's large-trader reporting system, Commission staff has taken steps toward implementing a special identification system for tracking index arbitrage activity. Commission staff also is exploring ways in which data currently collected and used by the Commission and futures exchanges for market and financial surveillance can be refined to enhance financial surveillance.

Even before the Working Group was formed, the CFTC was consulting with the SEC, the Federal Reserve Board and the Department of the Treasury to address intermarket coordination and contingency planning issues raised by the market break. In addition, the CFTC is coordinating with foreign regulators in a number of areas including financial surveillance and information sharing.

While the CFTC's staff reports reflect that existing regulatory and self-regulatory protections functioned effectively during October 1987, the CFTC has carefully reviewed SRO programs, as well as its own systems, to identify areas which can be strengthened. The CFTC has actively monitored the activities of futures SROs in response to these recommendations and encouraged enhanced coordination among futures exchanges, securities exchanges and clearing banks involved in the futures and securities settlement processes. As a result, the futures SROs have effected many system improvements since the market break which respond to the CFTC's recommendations and have taken steps toward more formal inter-market coordination.