

Regulatory Jurisdiction: What
Motivates the Call for Reform?

We at the CFTC take special pride in our role over the past 15 years in overseeing the tremendous growth of the futures industry. Much has happened in the futures markets since CFTC opened its doors in April 1975. Yet in some ways 1990 looks like 1975:

- Washington still doesn't have a baseball team
- There is a vacancy on the CFTC
- The Federal Reserve Board is concerned about inflation
- The Treasury is concerned about CFTC's exclusive jurisdiction
- And SEC just wants it.

In some ways I can't blame them. Under the regulation of the CFTC, the U.S. futures markets are the largest, the most liquid, and the most innovative in the world. Our regulatory system and the successes of our futures markets are imitated worldwide as others scramble to compete.

But this is not 1975 and we should not sanction a return to the past. Why does SEC want CFTC jurisdiction? There are two motives. First, SEC wants more regulatory power -- a move that has been aptly described by one former SEC Commissioner as “regulatory imperialism”. Second, some on Wall Street want to turn back the clock to an earlier time. It shouldn’t surprise anyone that the securities sector is jealous of the performance and market share of the futures markets. They’ve had to watch as the futures markets continue to grow and innovate while the retail securities brokerage business declines, and with it, U.S. prominence in world equity markets. Rather than compete directly with financially innovative firms and products or respond to a fast changing economic landscape, they, under the umbrella of the SEC, want to regain better times simply by grabbing the successes of the futures markets.

Why am I so certain that these two motives are behind the debate? Very simple. The reasons given in support of any jurisdictional change have the staying power of a snowflake in July. As soon as the ever changing claims are exposed to objective analysis, they immediately evaporate.

One early argument was that futures caused the stock market crash of 1987. How could the stock markets plummet? No matter that stock values, as measured by price-to earning ratios, exceeded historic levels. No matter that the stock market had rallied virtually uninterrupted for five years to unexpected heights. In 1982 for example, the Dow was 884. By September 1987 the Dow had risen above 2500.

Yes, the stock market fell dramatically in October 1987. And like Inspector Reynaud in Casablanca, critics of futures were quick to call for a round-up of their usual suspects -- stock index futures. What better time to bring the upstart futures industry into line than in the moment when the visions of 1929 were being invoked by market commentators.

I do not mean to imply that concern about the October 1987 events are unwarranted. I do not underestimate the need for the Federal government to examine the basic mechanisms of the financial markets to ensure their integrity and security. The events of October 1989 underscore this need.

But effort that should be spent on useful market reforms is being sidetracked by this unproductive, time-consuming, and competitively damaging turf fight.

Will jurisdictional change result in any of the needed reforms? Are there any real issues that a change in jurisdiction can fix?

Let's review the arguments. Initially we heard the following: stock index futures and low margins cause excessive stock market volatility and are driving individual investors away from the market.

In fact, stock index futures did not drive the small investor from the market. The evidence is clear. Direct participation in the stock market by individuals has declined, but the decline began in the 1960s and for the most part ended in the mid-1970s, before stock index

futures or index arbitrage had even appeared. Individual investors are still in the market, but now they participate through institutions, designed for such investors -- pension funds, mutual funds, and pools.

As for the notion that futures cause volatility -- remember that volatility in cash markets cause futures to be traded. Financial experts are learning what farmers learned long ago -- that price risk can be managed effectively and efficiently through futures and options. And the academic research confirms this -- cash market volatility decreases when futures are introduced.

As for margins and volatility -- economists have searched for but not found a systematic relationship between futures margins and stock market volatility. Chairman Greenspan in his testimony to Congress on March 29 summarized the results of all of this research:

“(A)ll the analytical tools we have brought to bear have failed to find any such relationship. . .[E]fforts to restrain volatility by imposing more restriction on particular markets or instruments could have unintended effects resulting in significant costs on the system and a shifting of transactions activity offshore.”

But when objective analysis could not be found to support these claims, the proponents of this battle had to go back to the locker room to regroup and then redesign their arguments. More recently, we have been told that low futures margins entice traders to enter the market. Then a market decline causes them to liquidate their positions to meet margin calls, because margins have to be immediately raised.

Again, this new claim just doesn't fit the facts. 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.

It is ironic that the immediate margin adjustments made by the futures exchanges should be used as an example of structural or regulatory weakness in the futures markets. In fact these adjustments demonstrate the responsiveness of futures markets. The futures markets should not be radically restructured to accommodate unsubstantiated theories or to coincide with stock margins whose purpose is so very different.

The exchanges' response in October 1987 also demonstrates the problem with giving routine margin authority to any government agency. Government is simply not as well-equipped to adjust margins quickly -- sometimes on a daily basis. The Chicago Board of Trade in 1987 changed margin levels over 200 times. Can you imagine the CFTC or the SEC meeting these demands?

If margin authority were given to the SEC, what would be the outcome? Chairman Breeden has suggested a "national speed limit," or minimum of 20 percent for stock index futures margin to be more in line with securities margin. To call for such an inflexible standard fails to recognize the fundamental differences between the futures and securities markets and the role of margins in each. A "speed limit" would not return the stock market to the staid and stable horse and buggy era. It would drive the futures from the U.S. highways to foreign byways where speed limits are set based on economic reality, not nostalgia.

The proponents of merger also argue that the exclusive jurisdiction clause of the Commodity Exchange Act has blocked product innovation and driven some new products offshore. Index participation units are cited as the prime example.

But the IPs issue has nothing to do with stifling innovation.

And it is not true that any instrument with a bit of futurity is a futures contract and therefore within the CFTC's exclusive jurisdiction. The CFTC has taken action to define its mandate pragmatically to accommodate the development of new financial products. We have taken steps to clarify when a product must be regulated as a futures contract. Our jurisdictional exclusion and hybrid product exemption as well as our policy statement for commodity swaps reflect this pragmatic approach. And there continue to be new issues that arise that require understanding of and responsiveness to market issues -- as the Advisory regarding the Brent oil market suggests.

We have not used our exclusive jurisdiction as a barrier to innovation or as a launching pad from which to increase our turf. Instead, we have exercised our jurisdiction within the scope and purpose of the Commodity Exchange Act. Our record in the courtroom confirms this -- particularly when compared with the record of the SEC.

Eliminating this exclusive jurisdiction could result in regulatory chaos by allowing futures, which all have the same economic purpose, to be regulated under multiple and different regulatory systems. It would invite the states or other Federal regulators to impose rules,

sometimes even conflicting rules, that could undermine the efficiency of futures markets as international hedging and price discovery instruments.

Another jurisdictional argument we have heard is that because stock index futures are derivatives of stock, they should be regulated by the cash market regulator. This lesser jurisdictional alternative, transfer of stock index futures jurisdiction alone, is also unacceptable. The GAO warned in 1974 that a potential conflict of interest might exist if the new CFTC were located within the Department of Agriculture which had an institutional interest in stable or higher prices for agricultural commodities. The SEC has a similar interest in stable or higher stock prices. The futures regulator, however, must be insulated from pressure for either higher or lower prices in order to maintain strict price neutrality for hedgers on both sides of the market.

The only reason to shift stock index futures jurisdiction would be to change the rules governing stock index futures. But this then introduces problems of dual regulation of futures exchanges and increased costs to both government and market users.

Regulating stock index futures as “securities” would generate a host of legal and business complications. It would place futures in a hostile regulatory environment that could undermine their use as efficient hedging tools and could ban legitimate trading practices that now exist. Restricting the use of futures -- by imposing higher margins, or limiting index arbitrage, for instance -- impairs market liquidity, performance, and efficiency. Most importantly, it increases the costs of risk management and thus the costs of using the securities markets.

Proposals to shift portions of the CFTC budget to the SEC so they might administer parts of the Commodity Exchange Act for the purpose of regulating stock index futures would only increase regulatory costs and confusion. This approach sounds like the worst sort of a government hybrid. Not exactly merger and not exactly a shift of jurisdiction. Talk about regulatory fragmentation. I'm not sure what to say about this proposal, but I'm pretty sure it's not a futures contract.

I believe the present jurisdictional attack in part is premised on the perception that the Chicago trading abuses detected by the FBI demonstrate regulatory defects in the CFTC. I have not heard such statements about the SEC, although the FBI was involved in the detection of penny stock fraud cases. And such statements were not heard when the SEC became embroiled with the massive insider stock trading scandals of the 1980s, which were discovered often through tips from disgruntled employees.

No such charges against the SEC are warranted. And neither are such charges against the CFTC. For whatever reason, some choose to ignore the fact that CFTC was involved in the Chicago investigation from the outset. And they ignore the fact that CFTC has a long history of cooperative law enforcement with the states and with other federal authorities, including the SEC.

We at the CFTC are proud of what we have accomplished with a staff and budget smaller than other financial regulators. We have overseen the most innovative expansion of financial products in this country's history. We have overseen the introduction of this country's first

international exchange linkage and automated international trading system. The success of the U.S. futures markets is in large part a consequence of the current regulatory structure.

Are we perfect? No. Is there room to improve? Yes. But the facts do not warrant a jurisdictional change of any kind. Furthermore, the jurisdictional changes that are proposed do not solve the securities industry's real problems.

I believe that this examination of the facts has given an airtight alibi to futures. We should not rush to judgment and sentence stock index futures to life imprisonment at the SEC (where we fear their health may suffer).

We need to maintain the health and stability of both the futures and securities markets. To do so, we should each do what we do best. It is time to stop this recurring and unproductive battle. Let's enact important market reform legislation for both industries. This would allow the SEC to apply its resources and talent to improving our capital markets, reducing the costs of raising capital and encouraging the product innovation that is possible under current law.

For our part, we want to focus on what is most important for continued success of the U.S. futures markets and more broadly the U.S. economy. If we waste resources on domestic jurisdictional battles, we will lose the war. We must be prepared to compete in an ever changing political and economic environment. We must meet the regulatory challenges of new markets and innovations in existing markets -- both on and off-exchange. In order to meet these challenges successfully we must work together.