Statement of
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Before the
U.S. Senate Committee on
Agriculture, Nutrition, and Forestry

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Chairman Leahy, Senator Lugar, and Members of the Committee:

Thank you for this opportunity to discuss the Administration's views on regulatory fragmentation and related issues in the securities and futures markets. We believe the time has come to reform the disjointed regulation of the markets governing stocks, stock options, and stock index futures.

We also believe that if steps are not taken to correct the problem now, we are more likely to see minor events trigger major market disruptions like the breaks in October of 1987 and October of 1989 -- and the appropriate regulatory tools will not be in place to help contain the risk to this country's financial system. Finally, a failure to act will impede innovation; drive new financial instruments to overseas markets; and thwart enforcement of intermarket abuses.

As Secretary Brady has said many times, any reform must be based upon the fact that the markets for stocks, stock options, and stock index futures are really "one market." The financial community already recognizes this fact, as do regulators in other countries. The question is whether our regulatory structure

needs change in order to recognize this fact as well -- whether one market requires one regulator, and whether this will result in progress on key intermarket issues that will reduce the likelihood and risk of major market disruptions.

We believe the answer to all these questions is yes. As a result, the Administration will submit proposed legislation this week. Before outlining this proposal, however, let me explain why the Administration has come to this position.

The Onset of Major Market Disruptions

As this Committee knows, stock index futures began trading on futures exchanges less than ten years ago. These instruments have proved to be one of our financial system's most innovative new developments, and we believe their use has helped keep our cost of capital lower than it otherwise would be. They have also permitted institutional traders to engage in more effective asset allocation techniques and have provided a more flexible mechanism to enter and exit the stock market.

Nevertheless, the interaction of these new instruments with stocks and stock options has been an important contributor to major market disruptions -- periods when the markets disconnect with prices spiraling down. These major market disruptions are not episodes of markets adjusting to fundamental changes in value

or responding to major news events. They are periods when the markets break down, as history has shown us.

In the 52 years between 1930 and 1982 (the year stock index futures began trading) the Dow Jones Industrial Average declined by more than 6 percent on only three occasions: when the Germans took the Netherlands in May of 1940 (6.8 percent); when they encircled the Allied forces at Dunkirk just days later in the same month (6.8 percent); and when President Eisenhower suffered a heart attack in September of 1955 (6.5 percent). As the futures markets have grown, such massive one-day selloffs have occurred four times in the last three years:

October 19, 1987 -- 22.6 percent
October 26, 1987 -- 8.0 percent
January 8, 1988 -- 6.9 percent
October 13, 1989 -- 6.9 percent

Not one of these days corresponded with any major news events like the ones before 1982. But they all shared the characteristic of enormous selling pressure from the stock index futures markets.

Again, these were not merely days of "excessive price fluctuations" or "increased volatility." Beginning with the Report of the Presidential Task Force on Market Mechanisms,

chaired by Secretary Brady, we have consistently recognized that there is no compelling evidence that average stock market volatility has increased over the past 25 years. But that is completely beside the point.

The problem is not an increase in average price volatility, but the infrequent episodes of violent disruptions when the markets cease to function correctly. During these episodes, pricing relationships between stocks and futures break down; markets in particular instruments experience difficulties in staying open; serious supply-demand imbalances develop; and very large market moves occur in the absence of underlying fundamental information.

It is the increased potential for and consequences of these major market disruptions that lead us to urge prompt regulatory reform.

Systemic Risk and Erosion of Investor Confidence

The most disturbing consequence is the risk these major market disruptions pose to the entire financial system, especially through the clearance and settlement process. For example, after the October 1987 break, the clearance and settlement system fell over 6 hours behind its normal payment times, with futures clearinghouses owing over $1.5 billion to

investment houses. Had these funds been missing for any significantly longer time, it would have unleashed a chain reaction of events where other payments to other creditors would not have been made. The Presidential Task Force concluded that the prospect of clearinghouse failures reduced the willingness of lenders to finance market participants, leading to "a crisis of confidence [that] raised the spectre of a full-scale financial system breakdown."

Obviously, we must take appropriate steps to reduce this very real risk of systemic breakdown.

Moreover, we need to address another consequence of these major market disruptions -- their contribution to the erosion of investor confidence and capital formation:

- Initial Public Offerings (IPOs) have plummeted since the 1987 market break. After peaking at $18 billion in 1986, IPOs raised only about $6 billion a year in 1988 and 1989.

- Equity offerings as a percentage of new funds raised domestically has fallen off dramatically. In the early 1980s, equity accounted for about 30-50 percent of all public new issues, but the share dwindled to only 10 percent in 1989.

- The percentage of stock outstanding held by individuals has declined from 84 percent in 1965 to 55 percent in 1989.

- Trading volume in options, futures, and stocks is off substantially from levels that prevailed before the October 1987 market break.

To bring investors back into our markets to stay, we must renew their confidence that market mechanisms are operating efficiently and that they are still a safe place to invest.

Regulatory Fragmentation

The fundamental impediment to reducing the likelihood of major market disruptions -- and its consequences to the system and to investors -- is regulatory fragmentation. One regulator for the "one market" would have much more flexibility to coordinate the key intermarket mechanisms that disconnect to create or exacerbate major market disruptions. These include the following.

Clearance and Settlement. I have already described the systemic risks posed by potential breakdowns in the clearance and settlement systems. This continues to be what Secretary Brady has described as the weakest link in the financial system. The problem is the fragmentation of clearing systems among the

stock, stock options, and stock index futures markets. While legislation is pending in both the Senate and House to help address these systems, there is little doubt that a single regulator could help accelerate the coordination process.

Unharmonized Margins. While there is federal oversight of margins in the stock and stock options markets, there is virtually none in the stock index futures markets. The result is a tremendous disparity among margin levels in the three markets, with futures margins often dipping to dangerously low levels. The fact is that futures traders can control so great an amount of stock with so little of their own money that relatively small amounts of capital can concentrate enormous selling pressure on the stock market -- great enough to cause a major market disruption that could punch a hole in the fabric of the financial system.

For example, just prior to the October 13, 1989 break, a professional trader in the futures market with $50,000 in cash could control almost $2,000,000 in stock, which is nearly 10 times more than the $200,000 that a professional trader in the stock market can control with the same amount of cash. Many observers were astounded that, while stock index futures margins were increased temporarily in the wake of the October 1987 break, they were actually lower in October of 1989 than they were in October of 1987.

The result is that during market downdrafts, when the system is most in need of liquidity, futures exchanges are forced to restrict liquidity through margin calls because margins have been set so low. This is precisely the opposite of what should occur: during emergencies it is critical to pump liquidity into the system.

Thus, low futures margins create a direct prudential risk not merely to the futures markets, but to the financial system as a whole. However, since these margins are set by the futures industry, with no day-to-day regulatory oversight, there is no way to harmonize margins between futures and stocks to protect the public. This exposure to systemic risk requires federal oversight of margin-setting for stock index futures, and the oversight should come from one regulator that can ensure harmonized margins among linked markets.

Evasion of Short Selling Restrictions. For over 50 years the securities laws have restricted bear raiders like the 1920s' Jessie Livermore from selling short in declining markets. The purpose of these restrictions is to prevent "gunning" the market, which drives down the market and confuses the small investor. However, a concerted selling effort in the futures market can completely undermine the short selling restriction -- and in fact, because of low futures margins, can accelerate the

stock market downdraft. Again, it is critical to harmonize these intermarket rules to prevent manipulators from using one market to evade restrictions in another market.

Uncoordinated Circuit Breakers. Some progress has been made to coordinate circuit breakers in stock and stock index futures markets, and discussions are continuing within the President's Working Group on Financial Markets. Nevertheless, more can be done, and fundamental disagreements continue to exist between markets and their regulators over the appropriate kinds of circuit breakers.

In short, fragmented regulation has impeded progress on the coordination of these fundamental intermarket mechanisms. We believe one regulator with appropriate authority could accelerate progress substantially towards the harmonized regulation we need to address the problem of major market disruptions.

Barriers to Innovation

Apart from major market disruptions, regulatory fragmentation is now creating a serious impediment to innovation. This was not always true -- in the past, fragmented regulation sometimes promoted innovation. Competition between Chicago and New York markets spurred new product development,

while the practices of different regulators often promoted diversity, experimentation, and creativity.

But regulatory competition also begets jurisdictional squabbles, which can strangle innovation. New products are not merely stifled; they quickly move to overseas markets.

This is particularly true with respect to the so-called "exclusivity" clause of the Commodity Exchange Act (CEA). As a result of regulatory disputes, the courts currently interpret this provision to require that <u>any</u> financial instrument with <u>any</u> degree of "futurity" must be traded on a futures exchange. But certain of the new "hybrid" products are simply not amenable to trading in this manner. The result has been protracted litigation over what constitutes a "future"; an inability to trade in the U.S. markets most suited to the product; and the shifting of business to more hospitable overseas markets. This is precisely what happened to Index Participation Certificates, which now trade in Toronto rather than the United States.

My point is this: with the globalization of financial markets, other countries have provided us all the regulatory competition we need. We can no longer afford jurisdictional conflicts that stifle innovation at home and drive important business overseas.

Enforcement and Globalization

The other problems created by regulatory fragmentation involve intermarket enforcement and globalization.

Ineffective Intermarket Enforcement. With two different regulators, it becomes extremely difficult to prevent manipulation and fraud in transactions between the stock and futures markets. The situation is similar to state troopers who are forced to stop at the state line when chasing lawbreakers. In particular, it is extremely difficult to detect intermarket "frontrunning," where a trader trades ahead of his client in one market knowing that the client's trade will drive a linked market in a particular direction. In fact, at this time there is not even a universally accepted definition of illegal frontrunning in the cross-market context.

The plain fact is that with our current system it is simply too easy for intermarket abuses to slip through the cracks because of the dispersion of regulatory responsibility. Integrated regulation would enhance surveillance, facilitate intermarket rulemaking, and promote accountability.

Globalization. The clear trend toward globalization of financial markets has now been recognized. I have already discussed how this overseas competition requires the United

States take the steps necessary to foster domestic innovation. But it also requires viewing interrelated domestic markets in a global context and speaking with one voice to our foreign counterparts.

Secretary Brady, testifying before the Senate Banking Committee last October, described the growing interdependence of the world's financial markets and supported the idea of identifying particular issues where an international and intermarket approach would be useful. Integrating "one market" regulation in the U.S. would obviously facilitate the process. In addition, integrated regulation would enable us to deal more effectively with foreign governments by speaking in a unified and consistent way.

Indeed, every other country with major trading in stocks and stock index futures has a single regulator to make sure its financial system as a whole is protected. Japan, the United Kingdom, and France, which together with the United States account for 90 percent of global futures trading, recognize the "one market" reality -- each country assures that regulation of stocks, options, and futures is coordinated by a single regulator. Yet here in the United States, by reason of historical accident, the Securities and Exchange Commission (SEC) regulates stocks and stock options, while the Commodity Futures Trading Commission (CFTC) regulates stock index futures.

Recommended Solutions

Before outlining the Administration's proposal, let me emphasize the importance of avoiding an approach that will stifle innovation. This is the effort to ban or drastically curtail program trading. We believe that this blunt approach of government intervention is simply the wrong way to address these problems. Rather than trying to restrict particular trading strategies, it is much more productive to focus on inconsistent intermarket regulation.

Again, to do this we must recognize that what we now have is a single market with uncoordinated and even conflicting regulation. That may have created benefits in the past when markets were less connected and overseas competition was minimal. But now it creates substantial problems, as I have just described.

The solution is not complicated. We do not need more regulation. But we do need more unified regulation as the umbrella under which specific intermarket issues can be much more easily resolved. The result will be more streamlined and efficient regulation.

Unifying regulation could involve the more substantial action of merging the SEC and the CFTC, as some members of Congress have suggested. Another approach would shift the regulation of all financial futures from the CFTC to the SEC. However, both of these proposals involve major regulatory changes that are more than is necessary to address the problems we believe require immediate correction.

Instead, the Administration supports a less sweeping approach that would only unify regulation of the "one market" of stocks, stock options, and stock index futures under the SEC, the agency with the greatest expertise in the combination of these products. The proposal the Administration will submit will:

-- Shift regulatory authority for stock index futures to the SEC, but 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, which would be similar to its current oversight authority over margin-setting by the options exchanges (there would be no pre-set minimum margins established by statute);

-- Modify the "exclusivity clause" of the Commodity Exchange Act in order to end pointless litigation and remove barriers to innovation that are driving new products to foreign markets;

-- Enhance enforcement authority, especially on an intermarket basis;

-- Provide for appropriate transition; and

-- Mandate reports within eighteen months on any additional modifications that are necessary for the efficient regulation of the "one market" of stocks, stock options, and stock index futures.

The Administration believes that this is the most appropriate approach for addressing regulatory fragmentation with the least disturbance to and best protection for the futures markets. Moreover, it would have no effect on the agricultural community, since stock index futures have no relation to agricultural products or agricultural futures.

The proposal would also minimize the effect on the CFTC, because stock index futures represent less than 10 percent of the futures volume under CFTC jurisdiction. Indeed, the CFTC will be able to concentrate its considerable expertise on the more

traditional agricultural and financial futures products that have long been the core of its jurisdiction.

Conclusion

In conclusion, the benefits of unified regulation are substantial. While we embrace this approach, I want to emphasize our belief that today's problems do not come from the regulators themselves. Both the CFTC and the SEC are doing a good job under difficult circumstances -- administering a scheme of regulation that simply is not designed for the unified marketplace they are expected to regulate. We believe the answer is a coherent regulatory structure that can deal effectively with unified markets. Resolving regulatory fragmentation will reduce systemic risk and promote investor confidence, which are keys to our long-term competitiveness.

Moreover, led by Chairman Gramm, I believe the CFTC will continue its outstanding job of ensuring the integrity and safety and soundness of the markets it regulates. I urge the Senate to speedily confirm Chairman Gramm for another term, so that the CFTC will have the leadership necessary to address these matters successfully.

Mr. Chairman, that concludes my testimony. I would be pleased to answer any questions the Committee may have.

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