STATEMENT
OF
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THE OPTIONS CLEARING CORPORATION

BEFORE THE
UNITED STATES SENATE COMMITTEE ON
BANKING, HOUSING AND URBAN AFFAIRS

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Mr. Chairman, my name is Wayne Luthringshausen. I am Chairman of the Board of The Options Clearing Corporation (the "OCC") which is the common clearing and settlement agency for all exchange-traded, Securities and Exchange Commission ("SEC") regulated securities options. Our subsidiary, The Intermarket Clearing Corporation (the "ICC"), serves as a clearing and settlement house for trades in futures contracts and commodity options on three commodities exchanges. As a result of our daily monitoring of trading activity, we have a clear and steady eye on the function and operation of the capital markets.

I am privileged to appear before the Committee today on behalf of the Ad Hoc Coalition for Intermarket Coordination. In addition to the OCC, the members of the Coalition are the American Stock Exchange, the Boston Stock Exchange, the Chicago Board Options Exchange, the Midwest Stock Exchange, the National Association of Securities Dealers, the National Securities Clearing Corporation, the Pacific Stock Exchange, and the Philadelphia Stock Exchange. These self-regulatory organizations -- located from coast to coast -- are active in virtually every aspect of America's securities industry.

The unity of purpose of the Coalition is noteworthy and remarkable. Its members represent broad segments of the securities industry and frequently are active and aggressive competitors. We have joined together because of our sense of urgency about the need to reform the system for regulating financial market instruments in order to remove obstacles to product innovation, to ensure the continued competitiveness of the United States capital markets, and to restore investor and issuer confidence in the integrity and stability of those markets.

It is a cold, sobering fact that for several years now Japan has rivaled the United States as the world's financial center. With the formation of the European Community, yet another aggressive challenge to U.S. financial leadership will emerge. The ability to raise capital efficiently is central to a strong and prosperous economy. Unfortunately, our Nation's capital markets are hamstrung by an irrational regulatory structure that, in many instances, has dampened product innovation and reduced competitiveness.

The market breaks of October 1987 and October 1989 clearly demonstrated what we have all known for some time: the markets for stocks and stock derivatives constitute, in economic terms, a single market. Because of the close linkages among the stock, stock option and stock-index futures markets, there is a compelling need for increased intermarket coordination to lessen the risk of market disruption and, even more importantly, to

guarantee that investors and issuers have access to efficient, cost-effective markets.

Most important, we agree with the Bush Administration that increased intermarket coordination is essential for guaranteeing the confidence of American investors in the stability and integrity of the markets. Investors must be assured that federal regulators are in a position to respond swiftly and adequately during periods of market volatility. Without such assurances, the current trend of declining investor participation and capital formation likely will continue.

The fragmentation of our regulatory system has, in short, undermined the competitiveness of our markets and therefore jeopardized capital investment in three ways. First, it has rendered difficult the type of effective regulatory coordination that instills investor and issuer confidence. Second, it has prevented the implementation of coordinated margin rules that ensure efficient, sound investment decisions. Finally, the fragmentation has stifled the development of products that investors find useful and attractive.

The members of the Ad Hoc Coalition for Intermarket Coordination therefore strongly support the three major reforms set forth in the "Capital Markets Competition, Stability and Fairness Act of 1990": (1) the transfer of regulatory jurisdiction over stock-index futures to the SEC; (2) the consolidation of margin authority over stocks and stock derivatives under the SEC; and (3) modification of the exclusivity clause in Section 2(a) of the Commodity Exchange Act.

Effective Regulation: Unified Regulation of Stock, Stock Options and Stock-Index Futures

Although the stock, stock options and stock-index futures markets are now regulated by different government authorities and employ very different clearing structures, the economic reality is that these markets are closely joined by common underlying products and trading strategies that cross traditional market boundaries. In short, the markets for stock, stock options and stock-index futures comprise a single, unified marketplace in which trading in any of the markets necessarily affects the others.

Investors, investment banks and other significant market participants readily recognize the connection of these markets. However, our current regulatory system is disconnected from that reality. The fragmentation of regulatory responsibility over the equity and equity-derivative markets forces the regulators to view the unified marketplace as distinct markets -- which has impeded the regulatory programs of both the SEC and the CFTC.

Because this regulatory myopia is at odds with the economic realities of the marketplace, it hamstrings the regulators' ability to respond quickly and fully in times of market stress. The market breaks of 1987 and 1989 clearly revealed that one agency must have the authority to respond to critical intermarket issues and to monitor and regulate intermarket activities.

The creation of unified regulatory authority over the equity and equity-derivative markets is especially critical to guarantee the confidence of investors and issuers in the

stability and integrity of our capital markets. Investors and other market participants need to be assured that adequate regulatory and other safeguards exist during times of market stress.

This Committee, the Brady Commission, the White House Working Group and others have identified a number of mechanisms to provide more effective intermarket coordination and to reduce the market dislocations created during periods of excessive volatility. Among these are coordinated circuit-breaker mechanisms, cross-margining authority, and coordinated clearing and settlement mechanisms. Proper implementation of these and other intermarket mechanisms is best and most directly furthered by a single federal regulator with authority over the full range of equity and derivative products.

By unifying the regulation of stocks, stock options and stock-index futures under the SEC, the Administration's proposal would permit effective intermarket coordination. This transfer of regulatory jurisdiction makes eminent sense not only because of the close linkages among the stock, stock option and stock-index future markets, but also because the SEC has the broadest expertise in regulating equity products. The transfer of regulatory authority over stock-index futures does not, in our view, reflect in any way upon the record or performance of the Commodity Futures Trading Commission ("CFTC"). It simply reflects the logical conclusion that a unified marketplace requires unified federal regulation. Moreover, the transfer to

the SEC of jurisdiction over stock-index futures would not require a radical departure from the current regulatory framework -- stock-index futures comprise but a small percentage of the transactions regulated by the CFTC.

Efficient, Sound Investment Decisions: Unified Regulation of Margins

As a further recognition of the unified marketplace for equity and equity-derivative products, we believe that there are important benefits to be gained from the consolidation of margin authority for stocks, stock options and stock-index futures under a single regulator -- the SEC. Coordinated margins would help assure that investors can make rational investment decisions and at the same time help guarantee sufficient liquidity in times of market stress. Under the current fragmented regulatory regime, margins cannot be adequately coordinated among equity-based products even though investors treat such products as part of a single market.

The issue of margin regulation has emerged as a major point of contention in the public debate over the Administration's proposal. In particular, some of the critics have argued that the SEC-regulated margins on securities options traded on the CBOE and cleared by OCC are not materially different from the margins required by futures exchange clearinghouses for CFTC-regulated stock-index futures. Thus, the critics conclude that there is no case for SEC regulation of futures margins because the SEC has required basically the same margins for CBOE-traded

options as the futures exchanges have required for stock-index futures. This observation, however, takes into account only half of the picture with respect to margins on securities options.

When we talk about margins on securities options, we have to look at margin requirements on two distinct levels: first, the clearinghouse margin that the broker/dealer must pay to OCC and, second, the customer margin that the option writer must pay to the broker/dealer. Dr. Gramm and others are quite correct in stating that the clearinghouse margin payable to OCC is comparable to that required by the futures clearinghouse. However, at the customer level, securities option writers are required to pay a <u>substantially</u> higher margin to the broker/dealer than the vast majority of futures customers are required to pay to the futures commission merchant. This higher customer margin affords the securities options markets a reservoir of liquidity to draw upon in case of a market downturn. That reservoir does not exist in the stock-index futures markets.

For example, let us compare the margin requirements for the CBOE-traded S&P 100 Stock-Index Option and those for the Merc-traded S&P 500 Stock-Index Futures Contract. At the clearinghouse level, the securities broker/dealer currently is required to post a margin with OCC providing protection for an approximate 4.5% adverse movement in the value of the S&P 100 Index. Similarly, on the Merc, the futures commission merchant is required to pay the clearinghouse a margin protecting against

the same approximate 4.5% adverse movement in the value of the S&P 500 Index. The comparison does not end here, however. So far, we are looking only at the clearinghouse margin requirement.

At the customer level, the broker/dealer executing an S&P 100 Index Option on the CBOE must collect from the option writer a margin equal to approximately 15% of the index's value. The futures commission merchant, on the other hand, when executing an S&P 500 Index Future on the Merc, collects a margin amounting to only approximately 4.5% of the index's value*/ -- less than one-third of the margin required on the SEC-regulated CBOE.

The securities broker/dealer retains that portion of the option writer's margin payment equal to 11.5% of the index value and passes along the remaining 4.5% to OCC. Thus, the broker/dealer retains a substantial cushion to guard against the risk of a downward price movement in the S&P 100 Index. Should such a movement occur, the broker/dealer has this cushion available to meet any additional margin calls imposed by OCC.

The futures commission merchant, however, obviously must pass along to the futures clearinghouse the entire 4.5% margin he collects from the futures customer -- leaving him with no cushion whatsoever to soften the impact of a downward price movement in the S&P 500 Index or a dramatic increase in margin protection in

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*The approximately 4.5% margin is required of nearly 95% of futures customers. A much smaller number of other futures markets participants, known as "speculators", are required to post margin in the amount of approximately 12% of the value of the underlying index.

times of stress. In the event of such a movement, the futures commission merchant is obligated to pay any additional margin required by the clearinghouse, whether or not he is able to collect the money from the futures customer. This predicament obviously creates cash flow strains on the futures system in times of extreme volatility and market stress -- draining liquidity from the markets when it is most needed.

Let there be no mistake about it. There is no question that the margins required on SEC-regulated securities options are substantially higher than those required on CFTC-regulated stock-index futures. That is true today and it was true prior to the market breaks of October 1987 and October 1989. There also is no question that the higher leverage that exists in the futures markets poses a significant risk to market liquidity during times of market stress.

Three out of four members of the White House Working Group are in agreement on this point, including Federal Reserve Chairman Greenspan. In testimony before the House Telecommunications and Finance Subcommittee on May 24, Chairman Greenspan stated that:

> [a]lthough no futures clearinghouse has ever suffered a loss from a default on a stock index futures contract, certain actions by futures exchanges and their clearinghouses 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...[This practice] tends to compound already substantial liquidity pressures on their customers, on lenders to their customers, and on other payment and clearing systems. (emphasis added)

Consolidating margin authority for stock, stock options and stock-index futures under the SEC will permit coordinated federal oversight of margins on these related products, thereby assuring that prudential margin levels will be maintained across the markets for equities and equity-derivatives. Consolidated margin authority offers other important benefits as well.

For example, margin-setting authority consolidated within the SEC would remove the regulatory obstacles to "cross-margining" -- an important market reform endorsed by the Brady Commission, the White House Working Group and the SEC as a needed and workable method of reducing credit and cash-flow problems in our markets. Cross-margining is designed to avoid any over-collateralization of the risk of intermarket hedge positions at the clearing house level and, consequently, for firms and their marketmakers and specialists. Cross-margining rationalizes credit requirements at prudential levels and operates to sustain or increase market liquidity, especially during times of stress. It takes the form of options and futures clearing houses sharing position information and liens for common clearing members and calculating an overall margin requirement based on the combined positions.

The OCC and its subsidiary, the ICC, initiated a pilot program which provides cross-margining of OCC-cleared securities

options with futures positions cleared by ICC. Currently, the OCC and the Chicago Mercantile Exchange are operating a substantial cross-margin pilot. As a result, during the October 1989 market break, two substantial clearing members were able to reduce their margin payment obligations by approximately $150 million, evidencing the effectiveness of cross-margining in reducing unnecessary demand for liquidity during times of market stress while not increasing risk to the system.

This successful cross-margining program has not been expanded beyond the proprietary accounts of the two firms due, in large part, to regulatory impediments. In particular, while many options marketmakers are extremely active in the stock-index futures market for hedging purposes, cross-margining has not been extended to marketmaker accounts. The transfer of margin authority to the SEC for stock-index futures would remove the regulatory impediments and permit options marketmakers to take advantage of the risk reduction inherent in intermarket hedge positions.

Margins control the level of capital necessary for investment; cross-margining not only enables capital levels to be prudential across markets but encourages intermarket trading strategies that facilitate rational price movements. It is for these reasons that unified margin regulation in general and cross-margining in particular are essential to efficient, sound market decisions. We believe that implementation of cross-margining must be the first change made upon the transfer of

margin-setting authority to the SEC.

We also believe it is important to emphasize that in setting coordinated margin requirements for stock-index futures and other equity-related products, the overriding concern should be to assure that margins are adequate to protect clearing organizations, brokers and other lenders from credit losses caused by price changes. We concur fully with Chairman Greenspan and the Federal Reserve Board that "the critical question is whether margins on stock-index futures have been maintained at levels that are adequate for prudential purposes."

Raising margins on stock-index futures to higher than prudential levels would not, for clearinghouse purposes, contribute to the safekeeping of our financial system. To the contrary, excessive margins serve only to threaten the liquidity of our markets and to make our foreign competitors more attractive to investors.

Product Innovation: Amendment of the Exclusivity Clause

The exclusivity clause in Section 2(a) of the Commodity Exchange Act, which vests the CFTC with exclusive jurisdiction over trading in futures contracts, creates a steel curtain between the securities and commodities markets. This rigorous, enforced separation has created jurisdictional controversy and confusion in our markets since 1974 -- particularly with respect to sophisticated, hybrid financial products which do not fit neatly into either the "security" or "future" category. As a result, the exclusivity provision poses a substantial barrier to

financial product innovation and to the continued international competitiveness of the American capital markets.

The federal courts have interpreted Section 2(a) of the Commodity Exchange Act to mean that the CFTC has exclusive jurisdiction over instruments that are securities within the meaning of the 1933 and 1934 Securities Acts -- if such instruments have <u>any</u> attribute whatsoever of a futures contract. This holding by the courts has a far-reaching effect on our capital markets. As Federal Reserve Chairman Greenspan has testified, "[i]n a very general sense, all financial instruments have an element of futurity in them, in that their value depends on future events."

A recent judicial interpretation of the exclusivity clause confirms that the piecemeal approach of the Shad-Johnson Accord in 1982 serves only to create serious regulatory dysfunctions which ultimately deprive financial markets of new and highly desirable products. Last year, the Seventh Circuit Court of Appeals, in deciding a lawsuit brought by two futures exchanges and in which the CFTC joined as amicus curiae, blocked the introduction of a new financial product -- the Index Participation or "IP".

The IP -- a "market basket" product representing a broad range of securities -- was designed by the American Stock Exchange, the Philadelphia Stock Exchange, the Chicago Board Options Exchange and the OCC to fill a critical gap, exposed by the October 1987 market break, in the range of available

investment instruments. In particular, IPs were designed to provide an additional layer of liquidity to the stock market, thereby enhancing the market's strength and stability. Unfortunately, the Seventh Circuit found that the IP contained some elements of a futures contract and was therefore subject to the CFTC's exclusive jurisdiction. Accordingly, IPs products cannot be traded on any securities exchange.

As the IPs case demonstrates, jurisdictional prerequisites, rather than market forces, now control the development of new financial instruments. The needs and demands of the investing public are secondary to the jurisdictional constraints imposed by the exclusivity clause. During the limited time when IPs were traded on the American Stock Exchange and the Philadelphia Stock Exchange, hundreds of investors bought these products despite uncertainties created by the pending litigation and despite the fact that a number of securities firms declined to market IPs products prior to the resolution of that litigation. Today, as a result of the court's interpretation of the exclusivity clause in the Commodity Exchange Act, IPs cannot be purchased in any U.S. market.

The IPs decision was a boon to our foreign competitors, however, because it allowed them to have the market for IPs-type products to themselves. Today IPs-type products enjoy active trading on the Toronto Stock Exchange, and plans are underway for trading in London. It should be noted that the commodity exchanges which fought to prevent the American Stock Exchange,

the Philadelphia Stock Exchange and the Chicago Board Options Exchange from trading IPs were not trading the products then, nor are they trading them today. Nor has any futures exchange announced any intention or interest in making IPs products available to the investing public.

As a result of the stifling effect of the exclusivity provision, U.S. capital markets ultimately may be incapable of meeting the rising demand for newly-developed stock derivative products. There is no adequate solution to this dilemma short of repeal or substantial amendment of the exclusivity clause. It is no answer -- as the CFTC has suggested -- that the remedy lies in cross-registration of securities account executives and futures associated persons.

The reasons for this are simple. IPs were designed to be marketed as investments for retail securities customers and to be traded like securities -- not like futures contracts. Most retail securities customers have never maintained a futures account. Those customers are accustomed to the protections of the securities laws -- mandatory disclosure, SIPC insurance, and the like -- and they are not accustomed to futures-style margins and the resultant daily cash payments that are required. Further, IPs were designed to be traded like securities. Both the American Stock Exchange and the Philadelphia Stock Exchange made a specialist responsible for maintaining continuous and orderly markets in IPs, but, as I understand it, the CFTC would not allow a specialist to maintain a futures market in IPs.

Moreover, the market-making capability of participants in an IPs securities market was enhanced by their ability to cross-margin their hedging positions in options and other securities; on the other hand, cross-margining between options and futures is still not a reality for marketmakers. Market-making ability in the securities markets is enhanced further by the fact that securities broker-dealers can accommodate orders of size through block trades, which cannot be done on futures markets. Finally, the IPs traded on the American Stock Exchange provided for the delivery of the underlying common stocks at the option of the holder, and this would have been illegal if IPs had traded as futures contracts.

It is thus unlikely that IPs could be successful as a futures product traded under the jurisdiction of the CFTC. It is not surprising that no securities exchange or commodity exchange has sought to make them available as a future. Instead, as recent events have proven, customers who wish to invest and trade in IPs-type products will need to turn to foreign securities exchanges.

Indeed, the IPs experience exposes the fallacy of the CFTC's oft-stated argument that divided regulatory jurisdiction enhances competitiveness and innovation. To the contrary, the CFTC's exclusive jurisdiction -- which is part and parcel of our current bifurcated regulatory system -- operates in many instances to stifle product innovation, particularly where the innovation threatens the vested interests of the futures

industry. This phenomenon promises to repeat itself again and again unless the exclusivity provision is repealed or modified.

Conclusion

The simple fact is that unless Congress acts to rationalize regulatory jurisdiction, the dysfunctions in the U.S. capital markets, and the consequent shift to foreign markets, will continue. Enactment of the Administration's proposal would constitute a major step forward in resolving the most critical regulatory problems facing our markets. The transfer of stock-index futures to the SEC, the consolidation of margin-setting authority under the SEC, and the elimination of the exclusivity clause would facilitate effective and necessary intermarket coordination with respect to equity-related products. The reforms would eliminate many of the competitive obstacles that now hinder America's capital markets and, most important, would help guarantee continued investor and issuer confidence.

Mr. Chairman, the swift passage of the Administration's regulatory proposal is necessary. The commitment of the diverse members of the Coalition to work together in spite of competitive differences underscores the urgency with which we view this problem. Our competitors throughout the world are moving swiftly and aggressively to build efficient and investor-responsive capital markets. We cannot allow arbitrary and artificial regulatory divisions to hamstring our ability to meet these competitive challenges.

Thank you very much.