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Statement by

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I appreciate the opportunity to appear before this subcommittee to discuss important issues related to the regulation of financial markets. Although these hearings were occasioned by the pending reauthorization of the CFTC and the associated legislation proposed to implement the jurisdictional agreement reached between that agency and the SEC, I think that in any case they would be quite appropriate at this time. The extremely rapid development of financial futures markets and the likely introduction of additional option and futures contracts highlight the need for Congress to review again the purposes and structure of federal regulation of these markets. I will be addressing some of these issues today, with particular emphasis on margin regulations, since that is an area in which Congress has given the Federal Reserve considerable direct authority.

Background

Our financial system has long offered participants a chance to hedge or speculate by entering into contracts for future delivery of a financial instrument. Until around 10 years ago, trading in such contracts was conducted over-the-counter, with participation generally limited to small numbers of sophisticated investors. Since the early 1970s, however, exchange trading has been established first for options on stock and subsequently for futures on a wide range of debt securities, foreign currencies and now on stock price indexes. Trading in these instruments has increased rapidly, spawning proposals to expand futures trading to contracts keyed on an ever-widening array of securities and to establish markets in options contracts on debt instruments, on indexes of stock prices, and even on futures contracts themselves.

The growth of options and futures markets reflects a number of different forces. The exchanges, for example, have shown great ingenuity in devising contracts to fulfill the public's desire to reduce risk or to match wits

with the market in projecting future movements in interest rates, stock prices, or foreign exchange values. More fundamentally, perhaps, the new instruments have found a receptive audience because of the volatility of the economic and financial environment in recent years, which has enhanced the desirability of hedging against price and interest rate movements and increased the potential for profits (and also losses) from speculation. I believe that the recent volatility is likely to subside as the economy successfully moves through the difficult transition to a more sustainable, noninflationary basis for growth. But even so, these new markets are likely to be a permanent feature of our financial landscape, and questions remain as to their appropriate regulation and to the contribution they make to the effective operation of the securities and capital markets.

In considering the possible effects of the wide array of new financial contracts, it is important to remember that these instruments are similar in a number of fundamental ways, although their specific provisions may differ. Futures, options and options on futures all are ways of transferring the risk of future price changes. They are sufficiently similar so that it is generally possible to determine how the prices of two such instruments keyed to the same underlying security ought to behave relative to each other, and relative to price changes in the underlying instrument. Some market participants follow these price relationships carefully, looking for opportunities to make profits if they get out of line. As a result of the activity of such arbitragers, these markets are tied very closely to one another, and developments in any one market will very quickly be transmitted to markets for related instruments.

Regulatory Structure

Given the fundamental similarity of these markets and the economic

forces binding them together, logic and sound public policy would seem to dictate that their regulation be comparable and parallel in fundamental respects. Of course, this need not apply to all regulation; some aspects must be keyed to the particular characteristics of the market or instrument involved, and regulation can serve different purposes in different markets. But if common features of related markets are subject to significantly different rules, the effective level of regulation will tend toward the weakest level. Attempts to protect a particular market sector from the effects of certain actions or to discourage certain practices are less likely to be successful in the absence of comparable rules in other markets linked by arbitrage to the protected sector.

Tendencies in this regard will be strengthened by the propensity for some market participants to seek out the less-regulated market, if the regulation is seen as constraining actions in any significant way or adding to costs. In this way, the less-protected market will be seen to have a competitive advantage, and pressures will be brought to bear to reduce regulation in other sectors. Rules and regulations thus can be a competitive factor, and their function in protecting the public interest may receive insufficient weight.

One way to promote evenhanded and coordinated regulation of related markets would be to place them under the same agency. The single regulator could balance the rules in the different markets to ensure that competitive balance and the public interest were both being served. Vesting authority in a single regulator is not essential, however. Similar results could be achieved when more than one agency is involved, provided that Congress endows the agencies with parallel regulatory powers that are then exercised in a coordinated way. In addition, the agencies must cooperate in surveillance and enforcement activities

across related markets, as has increasingly been occurring for securities and related instruments.

Thus, the kind of division of responsibilities agreed to by the CFTC and SEC seems reasonable and workable. In many respects SEC and CFTC regulation of their respective markets is already comparable. For example, both agencies have basically similar rules requiring the firms they supervise to meet minimum capitalization standards; this helps to assure investors and others doing business with the firms that they can meet their obligations. At the same time, the agencies have moved to enhance coordination and cooperation, including the development of procedures for interchange of information crucial to surveillance of markets. The Federal Reserve and the Treasury also share in this information as it affects markets of interest to them.

But in some important aspects of market regulation--especially margin requirements and rules designed to protect the interests of retail customers--notable differences between the two agencies remain that are not entirely related to dissimilarities in the basic nature of the markets they regulate. In these areas, the SEC (along with the Federal Reserve in the case of margins) has fairly stringent rules or exercises close oversight of exchange procedures, while the CFTC takes a different approach. The CFTC, constrained in part by its enabling legislation, places greater reliance on the judgment of participants to protect their own interests and less emphasis on the potential for more general disruptions stemming from difficulties in one of the markets it supervises. The accord between the two agencies does not affect this difference in regulatory outlook.

The degree to which government regulation of financial markets ought to constrain private participants is largely a matter of judgment. In general,

it is the Board's view that in a market economy the presumption ought always to favor maximum scope for private decision making, with government involvement justified only where it can be shown that it is needed to protect the general public well being. Because the financial markets play an important role in determining the level and composition of economic activity, the public has a strong interest in seeing to it that they continue to function smoothly. Most of our country's savings passes through financial markets, encouraged in part by the existence of liquid markets that make possible rapid changes in asset portfolios. The markets serve to channel these savings to business and household borrowers to finance capital formation, housing, and consumer purchases. They are an important channel through which monetary policy impulses are transmitted to the economy, and the forum in which federal and state and local governments must borrow to finance deficits and fund capital projects.

A wide variety of investors have been attracted to the new derivative instruments--options or futures--to hedge or speculate. And, the range of participants is likely to widen even further as additional stock index future contracts become available to be traded. The greater numbers of people and growing sums of money involved increase the potential that difficulties in one market may have effects extending beyond that sector. This certainly was illustrated by events in the silver market, which was being dominated by clearly speculative activity unrelated to the metal's use as an industrial commodity, where the 1980 crisis very nearly had serious consequences for financial markets more generally. This suggests a significant role for governmental regulation and oversight in financial futures markets--although this regulation should be kept to the minimum necessary to safeguard the public interest.

Moreover, the risk that rules established by private market participants may not adequately protect against market disruption may be greater at this time, when the markets are in a state of competitive flux. New instruments are being introduced constantly and the rivalry between the exchanges for business is especially intense since experience suggests that the first exchange to establish successful trading in contracts on a particular security or commodity has an advantage over later entrants. An exchange would not deliberately establish rules that expose its members to greatly enlarged risks, of course, but the possibility exists that it might be tempted to shade its standards at the inception of market trading in order to gain the initial advantage. This reinforces the present need for close oversight and review by federal regulatory agencies of exchange rules and practices.

Margin Requirements

Margin requirements are an area in which these public policy concerns are particularly sharply drawn. It is the one major type of market regulation the CFTC is explicitly barred from exercising or even overseeing, unless it can show an emergency already exists, and it is therefore an aspect of private rulemaking especially subject to competitive pressures. Moreover, this situation contrasts sharply with the securities markets, where the Federal Reserve sets initial margin requirements on equities and the SEC has the power to review the maintenance margins of the self-regulatory organizations. Thus, margin requirements are one prominent aspect of regulation in which similar instruments receive widely divergent treatment.

In part, this divergence reflects differences in the purposes of margins in the different markets. In commodities markets, margin deposits are

viewed as a performance bond--they are put up to guarantee that those who enter into the contract can meet its terms. They generally are equal to maximum price movements expected over a day or so, because at the end of each day payments are made between clearinghouses and the firms to reflect gains and losses on each futures contract; gains generally are passed through to customers and losses are met from customer margin deposits. If these payments reduce the cushion provided by margin deposits to levels below the minimum margin requirement, the loser can be called on to put up additional cash on short notice or risk being sold out. Since the exchanges and the firms comprising them are presumed to have the strongest interest in preventing defaults on contracts and the greatest knowledge of what is necessary to accomplish this, their judgment is relied upon to set the proper level of margins.

In securities markets, exchanges set maintenance margin levels to assure adequate protection for the creditor--equivalent in concept to the function performed by margins in the futures market--but the Federal Reserve establishes initial margin requirements to further the accomplishment of other objectives as well. Congress, in establishing the Federal Reserve's authority in this area, cited concerns about the diversion of credit from other uses, protecting investors by limiting leveraging possibilities, and preventing speculative bubbles in stock prices resulting from credit-financed purchases or sales to meet margin calls.

To be sure, there are more than just regulatory differences between futures margins and those in securities markets--especially cash markets. For example, the former need not normally involve traditional loans, although they may do so indirectly through borrowing to meet margins or use of bank letters of credit. But in one important sense they are quite similar. In both cases

the margins serve to limit the size of position that can be taken with a given amount of resources--dictating how much cash or collateral must be put up to participate in subsequent price movements of the instrument. And, by setting limits on the leveraging possibilities they affect the degree of risk that can be assumed by market participants. The function of margins in the futures and options markets is especially closely analogous, which is not surprising in light of the similarity of the two instruments.

This basic resemblance makes it necessary to evaluate margins in different markets with respect to their effect on leveraging possibilities. To the extent that control of leverage is an important goal of margins, failure to have roughly comparable regulation will tend to undermine the effects of the more stringent requirements, as well as create artificial competitive imbalances between markets. The development of such a situation with respect to stocks and instruments based on stocks would be of particular concern to the Federal Reserve, which has concentrated its margin regulation on equities markets. In recognition of this potential the Federal Reserve has asserted its authority over margins on futures contracts based on stock price indexes. Such a contract is in many respects functionally similar to an option, and if leveraging possibilities were allowed to expand substantially beyond those already available in equities, it would tend to reduce any effect the Federal Reserve's margin requirements were having in achieving their statutory objectives of protecting stock market investors or preventing speculative movements in stock prices. Investors in equity-related instruments could assume much more risky positions, and arbitrage between markets would quickly cause any speculative impulses originating in futures markets to be reflected in the stock market itself.

We have not yet mandated a margin level for futures on stock, since

the exchanges have agreed to keep their margins at what appears to be a reasonable level, but we have taken steps to begin putting into place the regulatory framework for possible future action. We are, I assure you, prepared to take appropriate action to assure that our margin requirement structure is not undermined or that differing margins do not create serious competitive imbalances among markets. While we do not believe it essential, it would be helpful in this regard for the Congress to clarify the authority of the Federal Reserve with respect to setting margins on equity-related instruments, thus avoiding unnecessary controversy and possible litigation.

The willingness of the Federal Reserve to use its margin-setting authority on stock index futures, together with the lack of evidence that trading in these contracts may cause harm to the economy and the stated intent of all concerned parties to monitor the development of these markets carefully, seem to us to argue against the imposition of a moratorium on this contract, as proposed in H.R. 5515. At the same time, I would note that several of us on the Board have some skepticism about the economic utility of this instrument, and we will be monitoring its use, activity, and possible effects on the stock market very closely.

The Federal Reserve has some margin authority over private debt securities, but in general we have not actively exercised it in recent years. We do not have authority over margins on securities issued by the federal or state and local governments, or their agencies. But there is still federal oversight in these areas exercised by the SEC, which since 1975 has been empowered to review the rules of the exchanges and other self-regulatory organizations--including maintenance margin standards--and to forestall the implementation of those it feels are inadequate. Congress gave the SEC this veto power to ensure

that the rules of the self-regulatory organizations were adequate to protect the working of the markets themselves--to minimize the chance of failure to perform in one part of the market and to limit the potential that any difficulties might spill over to other participants or markets. The decision-making power remains with the self-regulatory organizations, but the public interest in exchange decisions is protected by the SEC review process.

This suggests a model of use for margin regulation in financial futures markets. The Congress might consider granting some federal agency similar oversight powers over exchange margin practices in financial futures. Given the current structure of regulation, that authority could be vested in the CFTC, to be exercised in coordination with the SEC to assure that the margins required in various related markets are fair to the participants in those markets and protect the public interest in sound, smoothly functioning credit markets.

Remaining Issues

Even if this structure of regulation were to be established, a number of questions remain in the area of margin regulation. The Federal Reserve Bank of New York recently completed a comprehensive study of the Board's implementation of initial margin requirements in equity markets. The study noted the lack of evidence that our regulations had had any appreciable impact on stock price movements, although definitive conclusions in this area are not possible. It also made a number of suggestions for simplifying the regulations and reducing their burden on market participants, many of which we are now in the process of implementing. The New York Fed study, however, did not deal with several important aspects of margins, such as the need for federal oversight of maintenance margins for market protection purposes or of the role of margins in futures markets.

Nor did it address a number of other questions concerning the safeguarding of market mechanisms--such as the strength of the clearing corporations. We intend to discuss these important issues with our sister agencies and will report any further conclusions to you. Depending on the outcome of such an examination, Congress may want to redefine the purposes of margin regulations, especially in light of the numerous changes in financial market practices and regulations since 1934. Such a decision, in turn, might raise questions concerning the appropriate agency or agencies to administer the regulations. If the market protection function of margins were to be given primary emphasis, for example, consideration might be given to transferring margin authority from the Federal Reserve to the SEC and the CFTC. It is these agencies, after all, that have the detailed expertise in the functioning of markets under their supervision and that are responsible for implementing and monitoring other rules governing market and investor protection.