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Testimony by

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Chairman, Board of Governors of the Federal Reserve System

before the

Subcommittee on Securities

of the

Committee on Banking, Housing, and Urban Affairs

U S Senate

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Mr. Chairman, members of the subcommittee, it is a pleasure to appear on this panel this morning to discuss issues involving the regulation of securities markets. While your committee is addressing a broad range of matters in this area, you have asked me to focus on whether the existing split regulation of equities and index futures may have contributed to market volatility, interfered with the process of innovation, or led to enforcement problems. You also have asked for comment on certain proposals for regulatory consolidation. I would like to focus my remarks on three major issues: first, the adequacy of margin requirements on stock index futures as a prudential safeguard and the impact of existing margin-setting procedures and other differences in regulation on market volatility; second, existing impediments to innovation; and third, whether there is a need to modify the existing regulatory system for stocks and stock derivatives. My evaluation will be done against the objective of a regulatory structure that, while limiting risks to the system, results in highly efficient and innovative U.S. financial markets that can compete effectively in the global marketplace.

As I will discuss in more detail, the Board does not believe that the existing division of regulatory authority has increased volatility in the securities markets, nor in this regard is it a threat to the capital formation process. We continue to view the primary purpose of margins to be to protect the clearing organizations, brokers, and other intermediaries from credit losses that could jeopardize contract performance. While we think that federal oversight of margins is appropriate for prudential purposes, there are different views among

Board members on whether that authority is best vested in the Commodity Futures Trading Commission (CFTC) or the Securities and Exchange Commission (SEC)

On the broader issue of consolidating jurisdiction for stocks and stock index futures (or all financial futures) in one agency, there are good arguments for and against such a consolidation and, accordingly, differences of views on whether such consolidation would, on balance, be beneficial. We believe some changes to the existing regulatory system are necessary to avoid the prospect that jurisdictional disputes among regulators will impede innovation in our financial markets, but consolidation of jurisdiction is not necessary to achieve this objective.

Federal Margin Regulation

A prominent area of disagreement among those interested in the smooth functioning of our capital markets has been the appropriate level of margins for stock index futures and the need for federal authority over such margins. In part, these disagreements reflect different views as to the purposes of margins and the appropriate objectives of federal margin regulation. Accordingly, at the outset I would like to clarify the position of the Board of Governors on these issues.

We continue to believe that the primary objective of federal margin regulation should be to protect the financial integrity of market participants and thereby ensure contract performance. Margins should be adequate to protect clearing organizations, brokers, and other lenders from credit losses arising from changes in securities prices. As such, they are one important element of a package of prudential safeguards,

including capital requirements, liquidity requirements, and operational controls, aimed at limiting the vulnerability of the financial markets to losses or disruptions arising from the failure of one or more key participants. The failure of, or even the loss of public confidence in, a major intermediary in any of the stock, futures, or options markets could immediately place significant strains on other markets, their clearing systems, and on our nation's payment system.

The Board remains skeptical, however, of whether setting margins on stock index futures at levels higher than necessary for prudential purposes will reduce excessive stock price volatility. We, too, are concerned about what seems to be a higher frequency of large price movements in the equity markets, but we are not convinced that such movements can be attributed to the introduction of stock index futures and the opportunities they offer for greater leverage. Although available statistical evidence on the relationship between margins and stock price volatility is mixed, the preponderance of that evidence suggests that neither margins in the cash markets nor in the futures markets have affected volatility in any measurable manner. Moreover, we are concerned that raising maintenance margins on stock index futures to levels well above those necessary for prudential purposes could substantially reduce futures market liquidity or drive business offshore.

Thus, in the Board's view, the critical question is whether margins on stock index futures have been maintained at levels that are adequate for prudential purposes. Although no futures clearing house has ever suffered a loss from a default on a stock index futures

contract, certain actions by futures exchanges and their clearing houses 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. While such a practice has heretofore protected the financial interests of the clearing houses and their members, it tends to compound already substantial liquidity pressures on their customers, on lenders to their customers, and on other payment and clearing systems. In the Board's view, somewhat higher margin levels on stock index futures would obviate the need to raise them in a crisis and thereby reduce concerns about the reliability of our market mechanisms, especially clearing and payment systems, in times of adversity.

The Board believes that federal oversight is appropriate to ensure that margins on stocks and stock index futures are established at levels that are adequate under a wide range of market conditions. Futures self-regulatory organizations (SROs) should continue to have primary responsibility for developing and refining margin policies. But the appropriate federal agency should have both the authority to initiate changes in margins on stock index futures and the authority to veto changes proposed by the relevant SRO. That authority should not be limited to emergency authority such as the CFTC currently has over futures margins.

Either the CFTC or the SEC could play this role. The principal argument in favor of assigning oversight responsibility for stock index

futures to the CFTC is that it has overall responsibility for prudential supervision of futures exchanges and clearing organizations and futures commission merchants (FCMs). Assignment of oversight responsibility to the CFTC would avoid certain regulatory burdens and potential conflicts that could arise if responsibility for critical aspects of prudential oversight of such entities were divided between the CFTC and SEC.

The principal argument for assigning oversight responsibility for stock index futures margins to the SEC is that it would foster consistency of margins in the stock and stock derivative markets. The Board believes that margins in these markets should be consistent in the sense that they provide comparable protection against adverse price movements. The degree of protection provided by margin requirements depends on the magnitude of potential future price volatility. Although studies of past price movements can shed light on potential movements in the future, the forecasting of future volatility necessarily involves elements of judgment. Because different agencies are likely to come to different judgments, there is a case to be made for having only one regulator with margin authority over all the equity products markets to achieve consistency of margins across these markets.

On balance, the Board does not see a clear basis for choosing between CFTC and SEC oversight of stock index futures margins. The Board feels strongly, however, that authority should not be given to the Federal Reserve because it does not have overall prudential responsibility for any of the futures commission merchants (FCMs), broker/dealers, or clearing organizations that margins are intended to protect. The existing margin authority for stock and stock options

assigned to the Board under the Securities Exchange Act of 1934 should be transferred to the SROs and the SEC

Issues of Regulatory Jurisdiction

The question of regulatory responsibility for margins is one element of the broader question of regulatory jurisdiction over futures and options markets. In light of the strong linkages among the markets for futures, options, and their underlying instruments, some have argued that the division of oversight responsibilities among agencies may impede the effective regulation and supervision that is essential to ensure sound and efficient financial markets.

One particular concern relates to volatility. It is frequently argued that leveraged trading in stock-index futures and options, encouraged by low margin requirements on derivative products, has led to increased volatility in the prices of the underlying stocks. More generally, it has been suggested that other inconsistencies in market mechanisms involving, for example, circuit breakers and short-selling rules, contribute to market instability. It is feared that increased price volatility, in turn, will reduce the attractiveness of equity markets and could impede the capital formation process. These concerns have prompted calls for one regulator who will take steps to remove inconsistencies that may contribute to sharp price swings.

The Board does not share the view that split regulatory authority over equity instruments has in any meaningful way contributed to volatility. As I noted earlier, we have found no substantial evidence linking margin levels to price volatility in the cash or the index-product markets. Nor have studies revealed a clear understanding

of how circuit breakers and other market rules affect price movements in the different markets

In a more fundamental sense, we believe that it is counterproductive to lay blame on one sector, in this case the market for stock index derivatives, for the increasing occurrence of wide and rapid price swings in equity markets. Rather, the volatility we observe reflects more basic changes in economic and financial processes prompted by technological advances and the increasing concentration of assets in institutional portfolios. The delegation by the public of the management of a large proportion of its assets to professional managers through pension funds and other institutions and the desire of these managers for low-cost methods to manage risk and adjust portfolios has spurred growth in the new instruments, improvements in telecommunications and computer technology mean that information on economic fundamentals will be received and translated by these managers more quickly into market prices. To the extent that price movements reflect these basic forces, efforts to restrain volatility by imposing more restrictions on particular markets or instruments could have unintended effects, resulting in significant costs on the system and a shifting of transactions activity offshore.

A second issue frequently raised in evaluating the adequacy of our current regulatory system concerns product innovation. Many of the new products being developed on futures and options markets are not easy to classify. They have important similarities to, or are otherwise linked to, a variety of existing instruments subject to different regulators, and, as a consequence, various uncertainties and frictions

have emerged about the appropriate exchanges that should trade these instruments and the agencies that should provide regulatory oversight. One recent example involves the "index-participation" or IP contracts that were introduced by several of the stock exchanges, approved by the SEC for securities trading and, in essence, disapproved when the courts ruled that IPs were futures products subject to the exclusive jurisdiction of the CFTC and could not be traded off of exchanges regulated by the CFTC.

Under the Commodities Exchange Act (CEA), any commodity contract with an element of futurity cannot be entered into except on a CFTC-regulated exchange. Moreover, this act defines the term "commodity" very broadly to include not only physical commodities, like corn and wheat, but intangible contractual interests, including financial instruments. This restriction, when interpreted broadly, serves to discourage the development of new financial products that might be offered outside of the futures exchanges and tends to stifle the innovation process. In a very general sense, all financial instruments have an element of futurity in them, in that their value depends on future events. We believe the CEA can be modified in ways that preserve the public safeguards that motivated this provision, while preventing conflicts in this area from having to be dealt with by the courts and without impeding the process of innovation in equity and other instruments. Such modifications might include an exemption for transactions subject to other regulatory safeguards, sophisticated trader exemptions, or more stringent fraud liability.

Alternative Regulatory Structures

As I have noted, a case can be made for having only one federal agency with oversight authority over margins in the equity and equity derivative markets. This case rests not on the issue of volatility but on the fact that setting prudential margins requires judgments concerning potential future price volatility in the linked markets for stocks and derivative products. One regulator would provide a single view of potential future volatility in these markets and thereby foster consistency of margins across the various segments of the equity markets. Others would go further and transfer all regulatory authority over stock index futures and options on such futures to the SEC. This is one of the possibilities recently identified by Treasury Secretary Brady.

This alternative would help achieve consistent prudential regulation across these tightly linked markets for equity instruments. However, such a measure would result in two regulators of futures exchanges and futures clearing houses, and hence would still require a considerable amount of coordination on the part of the SEC and CFTC. One must recognize that stock index futures are but one of many futures contracts offered by these organizations--indeed, only one of many financial futures contracts. Should losses from stock index futures trading--to be subject to SEC regulation under this alternative--jeopardize the financial integrity of a clearing organization or futures brokerage firm (FCM), it would threaten contract performance on all of the futures traded by the entity, including tangible commodity futures. Similarly, a failure in the commodity futures markets could, because of

the effects on the clearing organization or brokerage firm, have consequences for the equity markets. In another area, many exchange rules related to trading and clearing cut across a wide range of contracts rather than being specific to stock index contracts, and close coordination between the SEC and CFTC would be important in evaluating such rules.

Thus, the SEC would have an important interest in other aspects of futures market regulation while the CFTC would continue to have a strong interest in the regulation of stock index futures. The logic of transferring stock index futures to the SEC because of their tight linkage to the cash market suggests that futures contracts on other instruments also might be regulated differently. That is, Treasury futures would be regulated by the Treasury and Eurodollar and foreign currency futures by the Federal Reserve. Such a change, however, would increase the regulatory fragmentation in the securities markets and would not appear to be a particularly useful realignment. Consequently, the benefits of transferring regulatory jurisdiction to the SEC for purposes of achieving more consistency of regulation across equity instruments must be balanced against these drawbacks, and there is scope for legitimate differences of view on whether such a measure would be a net improvement.

Secretary Brady also has suggested much more far-reaching measures to deal with the jurisdictional issue--the transferring of all financial products to the SEC or the merging of the two agencies. We would urge caution in considering these alternatives. A full merger of the two agencies would avoid many of the problems just mentioned about

overlapping jurisdiction in the regulation of exchanges and clearing houses, and the transfer of all financial instruments to the SEC might be accompanied by the separate clearing of all financial futures subject to only one regulator. However, these solutions would concentrate a great deal of regulatory authority over the financial system in a single agency and this has been a concern of Congress for a long time. In addition to the potential management difficulties of a larger organization, there is the risk that bureaucratic inertia in a larger agency could be an impediment to the process of innovation. We should not lose sight of the fact that under the existing system of split jurisdiction over financial instruments, our financial markets have been the most innovative in the world, with many of the new products spurred by the introduction of index futures and other futures.