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Statement by

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before the

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of the

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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 and useful at this time. The rapid development of financial futures markets and the likely onset of trading in many more new option and futures contracts have highlighted the need for Congress to address a number of fundamental questions concerning 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 one 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, however, trading in such contracts was conducted over-the-counter, with participation generally limited to small numbers of sophisticated investors. Beginning in the early 1970s we have seen the establishment first of exchange trading for options on stock then for futures on a wide range of debt securities and foreign currencies and now on stock price indexes. Trading in these instruments has expanded rapidly, spawning a host of proposals to expand futures trading to contracts keyed to 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

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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. Rapid and sizable changes in interest rates have enhanced the desirability of hedging against interest rate movements and increased the potential for profits (and also losses) from speculation. Changing inflation expectations have contributed to wide swings in the prices of precious metals and exchange rates have shown dramatic movements in response to sizable shifts in economic and financial conditions in various countries. I believe that much of the recent volatility is an unfortunate byproduct of an economy in transition to a period of sustainable noninflationary growth. Such a transition is, of necessity, marked by a great deal of uncertainty about the financial outlook--accentuated by the ~~prospects~~ potential for ~~extraordinarily~~ large budget deficits. If we adhere to our policy of seeking moderate growth in money and credit and rein in the federal government's financial needs, both economic and financial stability will be restored, with benefits flowing to the economy, if not to the futures and options exchanges. Even so, these markets are likely to be a permanent feature of our financial landscape, and questions remain as to the contribution they make to the effective and efficient operations of the security and capital markets.

In considering the possible effects of the ~~sometimes bewildering 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

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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 watch these price relationships very carefully, looking for opportunities to make profits if they get out of line. As a result of the activity of these arbitragers, these markets are tied very closely to one another, and developments in any one market will very quickly be transmitted to other 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 many important respects. Of course, ~~some regulation~~ this necessary level of reg must be keyed to the particular characteristics of the market or instrument involved, but if related markets are subject to significantly different rules for features common to them all, the ~~effective~~ desired level of regulation will tend to be the weakest level. Difficulties in one market--arising perhaps from a lack of regulation--will be quickly felt in closely related markets and attempts to protect a particular market sector from the effects of certain actions will not be successful if those actions can be carried out in other markets linked by arbitrage to the protected sector.

Tendencies in this regard would 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 seem to have a competi-

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tive advantage, and pressures will be brought to bear to reduce regulation in other sectors. Rules and regulations then become a competitive tool, and their function in protecting the public interest may receive insufficient weight.

One way to promote evenhanded and coordinated regulation of competing markets would be to place them under the same regulator. 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 necessary, however. Similar results can be achieved when more than one agency is involved, provided that Congress endows the agencies with similar regulatory powers that are then exercised in a coordinated way, and the agencies cooperate in surveillance and enforcement activities across related markets.

Thus, we have no objection in principle to the kind of division of responsibilities agreed to by the CFTC and SEC. In many respects SEC and CFTC regulation of their respective markets is already quite 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. Customers also are protected by both agencies through stringent rules governing the segregation of customer funds. At the same time, the agencies have moved to enhance coordination and cooperation, including establishing regular channels 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 notable differences between the two agencies remain--especially in the areas of margin

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requirements and suitability rules that place responsibility on sales representatives to avoid advising customers to engage in inappropriate trading activity. In these areas, the SEC (along with the Federal Reserve in the case of margins) has fairly stringent rules while the CFTC has none. This disparity reflects somewhat different approaches to regulation, embodied in part in the legislation under which the two agencies operate, with the CFTC placing greater reliance on the judgment of participants to protect their own interests, especially once they have been made aware of the risky nature of the markets. The accord between the two agencies will not affect this difference in regulation, which is inconsistent with the general principle that similar markets should operate under similar ground rules.

The degree to which government regulation of financial markets ought to constrain private participants is difficult to determine. There is a strong public interest in maintaining smoothly functioning financial markets, that likely transcends the private interests of individual participants in these markets. The financial markets play an important role in determining the level and composition of national output. 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 the fulcrum for transmitting monetary policy impulses to the economy, and the forum in which federal and state and local governments must borrow to finance deficits and fund capital projects such as schools and highways.

A wide variety of investors have been attracted to the new derivative instruments--options or futures--to hedge or speculate. And, the range

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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 for difficulties in one market segment to have effects well beyond that segment--much more so than is likely the case for most markets in traditional commodities. This certainly was illustrated by events in the silver market, which was being used in a manner more closely resembling a financial than a commodities market, where a crisis very nearly had serious consequences for other markets and several financial institutions as well. This suggests a somewhat greater role for governmental regulation in financial futures markets--although this regulation should be kept to the minimum necessary to safeguard the public interest.

Moreover, the danger that rules established by private market participants may not adequately protect against market disruptions is particularly great at this time. Futures and options 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 advantage over later entrants. Although no exchange would deliberately establish rules that expose itself to risk that endangered its viability, it might be tempted to shade its standards at the inception of market trading in order to gain the initial advantage. This only reinforces the need for closer 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

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regulation the CFTC is explicitly barred from exercising, even in an oversight capacity, and, although there is a strong self-interest in maintaining adequate margins, 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 to or from the clearinghouse to reflect gains and losses on each futures contract; if these payments reduce the cushion provided by margin deposits to levels that may not cover subsequent price moves, the loser can be called on to put up additional cash on short notice. Since market participants 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 guarantee performance on contracts, but the Federal Reserve establishes initial margin requirements to further the accomplishment of other objectives. For example, Congress in establishing the Federal Reserve's authority in this

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area cited its 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 the basic similarities are quite striking. 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 affecting leveraging possibilities they affect the degree of risk 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 resemblence makes it essential that comparable instruments be subject to comparable regulation. Failure to do this will undermine the effects of the more stringent regulations, frustrating the intent of the framers, as well as creating 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 moved to assert 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

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in the absence of Federal Reserve action the leveraging possibilities in equities would have expanded substantially, undermining to some extent any success the Federal Reserve's margin requirements were having in meeting their congressional objectives of protecting stock market investors or preventing speculative movements in stock prices. 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 protect the integrity of our margin requirements. It would be helpful in this regard for the Congress to adopt measures clarifying the responsibilities of the Federal Reserve with respect to setting margins on equity-related instruments, erasing any doubts about this matter.

The Federal Reserve has margin authority over private debt securities, but in general we have not actively exercised it in recent years. Moreover, we do not have authority over margins on securities issued by the federal or state and local governments. 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 SRO rules 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 for any difficulties that did occur to spill over to other participants or markets. The decision-making power remains with the SROs, but the public interest in exchange decisions is protected by the SEC review process.

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The Congress should consider granting some federal agency similar powers over exchange margin setting in financial futures. Given the current structure of regulation, that authority should probably 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 overwhelming public interest in sound, smoothly functioning credit markets.

Remaining Issues

Even with this structure of regulation established, many unresolved questions remain in the area of margin regulation. Congress may wish to ask the agencies involved to undertake a thorough review of margin regulation with a view to redefining its scope, purpose, and implementation in various financial markets. With respect to stock margins it might be time to take a good look at whether they have effectively fulfilled some of those congressional objectives I enumerated earlier. 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 additional emphasis, for example, initial margins would decline in importance relative to maintenance margin levels and authority might usefully be transferred from the Federal Reserve to the SEC, which has responsibility for reviewing most other rules governing market and investor protection in securities markets.

In the futures margin area, in addition to granting the CFTC authority to review exchange-set futures margins, Congress might want to instruct

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that such a study consider the form in which the margins are held--bank letters of credit are now acceptable in lieu of cash--and the way in which the gains and losses on futures contracts are settled each day. A related area that might profitably be examined is practices of the clearinghouses in obtaining margins from their members. The clearinghouses are at the hub of the futures market; difficulties in one of these might very quickly be felt throughout the financial markets.

In discussing these issues, I have not intended to prejudge the results of a thorough-going examination of margin regulations, or even to define or limit its scope. Indeed, it might be beneficial to expand such a study to encompass a host of issues related more generally to the regulation of new types of financial instruments and impact of their growth. It could address some of the concerns that motivated Chairman Dingall's proposal to impose a moratorium on stock index futures. Although I understand his concerns, I do not think such a step is necessary at this time--no persuasive case has been made that the financial markets will be harmed by this instrument, its trading can be closely observed as experience with it is gained, and the Federal Reserve stands ready to exercise its margin authority if appropriate.

The advent of stock index futures and many other new contracts is moving our financial system in new directions, and I don't think we've fully comprehended the implications of this. If asked by the Congress, the Federal Reserve stands ready to join with the other concerned regulatory agencies to take a comprehensive look at these markets, or we would support the use of a group of outside advisors for this purpose.

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Conclusion

Your consideration of the proper regulatory structure for financial futures and related markets is taking place at a time of intense questioning about the efficacy and scope of government regulation more generally. I think this is a healthy attitude. The presumption in a market economy ought always to be that government interference in market decisions requires strong justification and is open to continuing reexamination. I remain convinced, however, that there is an important role for federal government regulation and oversight in financial markets. Because these markets are at the very core of a modern economic system any problems they experience can have rapid and major ramifications on the general economic welfare.

The extent of regulation of financial markets necessary to protect the public interest is difficult to define, especially in light of the growth of new types of financial markets whose implications are not at all well understood. The study I proposed ~~in my discussion~~ was intended to give guidence to efforts to determine the proper role of government in the workings of financial markets, although I expect there are no definitive answers to these questions suitable for all times and circumstances. Nonetheless, one principle seems clear to me: whatever the extent of regulations, they must be applied in an evenhanded manner--similar instruments and markets should be subject to comparable and parallel regulations. In many respects, regulation of financial markets has been moving in this direction in recent years, but there is still some distance to go. I urge you to keep this in mind as you consider the important issues before you.

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