



REMARKS BEFORE THE NATIONAL ECONOMISTS CLUB

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WASHINGTON, D.C.

JUNE 5, 1990

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Remarks of Commissioner Mary L. Schapiro

before the National Economists Club

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Good afternoon. It's a pleasure to be here and to see so many friends. I was asked in an interview recently whether I thought there had been a shift in Commission philosophy recently because of the departures of Joe Grundfest and Charles Cox, the SEC's resident economist-commissioners. While I don't think there has been a dramatic change in thinking, I must tell you that the economists who have served on the Commission have made an enormous contribution and left behind an impressive legacy. Although unfortunately I am not an economist -- I ruled out that and medical school fairly early on -- economic principles and not solely legal ones, guide my decision making on many issues, and have a very significant effect on Commission policy.

I had planned to talk to you today about the internationalization of the markets from a somewhat different perspective than you most commonly hear. Last week, I was fortunate to be in Mexico to speak at a Seminar on the recent and quite remarkable economic developments in that country. I also spent two days while there working with the Developing Markets Committee of the International Organization of Securities

Commissions and had the opportunity to talk at length with securities regulators from Israel, Chile, Korea, Nigeria, India, Venezuela, Brazil, and a host of other countries. But, as I was preparing my remarks for you on the subject of internationalization, I was reminded that I had long ago agreed to talk to you about "the future of futures regulation". On the assumption that some of you, perhaps all, are here because of an interest in that subject, I won't disappoint you and that will be my topic. But, I must admit that I looked forward to talking about something different - in fact, I look forward these days to talking about anything but jurisdiction.

So, if you'll indulge me for just a moment, there is one small message that I would like to leave with you regarding the role of the SEC in the international arena.

You have no doubt read of the Commission's interest in Eastern Europe. You also probably know that we have formed an advisory committee on emerging markets through which we will marshal the energy and skill of industry leaders and academicians to assist the countries of Eastern Europe in the development of stock exchanges and financial regulatory systems. We have also been host to, among others, delegations from Poland, Hungary, and the Soviet Union and we have provided some training and technical assistance to them. I would like it to be clear however, that in our desire to support these newly emerging democracies in Europe, we are not and will not neglect the needs of developing markets in other parts of the world - most notably

in our own hemisphere. I have a strong commitment to ensuring that the assistance the SEC can provide other nations will be given in a spirit of equality. We would be foolish indeed to ignore the needs of countries such as Mexico, with whom we share a border, a tradition of capitalism and under the current regime - the leadership of President Salinas - an appreciation of the pivotal role of efficient securities markets in a vibrant economy.

Now, to the topic at hand. Let me start by saying that I am not the catalyst for change of the present jurisdictional structure. Anyone who has been around the CFTC for any period of time knows that virtually from the agency's creation in 1974, questions of jurisdiction have been posed and debated and litigated. One minute they seem to be resolved and the next minute, they are reborn. In ten years of practicing in this area, I have seen few issues, perhaps only audit trail and dual trading, that come close to inspiring as much passion and divisiveness. Certainly as economists you are aware that this debate has, and always has had the participation of very eminent legal and economic partisans. The "lining up of support" of notable economists in particular has become an important strategy. In fact, both sides claim the support of Federal Reserve Board Chairman Alan Greenspan - the swing vote on the White House Working Group - but, more than that, an economist held in the highest regard and perceived to have the least vested interest in how the turf is divided.

The debate today, has taken on a new character, largely because its terms have been framed by the active involvement of the Secretary of the Treasury. In at least two speeches in the month of March, Secretary Brady warned that the fragmentation of the US regulatory structure was hurting our competitiveness and innovation and contributing to excessive volatility. Without advocating one particular solution, he said, "what is important is that we get something done and get it done now".

In testimony before the Senate Banking Committee's subcommittee on Securities later on in March, Undersecretary of the Treasury, Robert Glauber said : "Instead of attempting to limit the use of futures, we need to find better ways to integrate them into the 'one market' so that they do not destabilize the system. A more integrated regulatory framework, I believe," Mr. Glauber continued , "will help avoid major disruptions and help make our financial system more stable, efficient, and competitive". Undersecretary Glauber then set forth three possible solutions: merger of the SEC and CFTC, unification of regulation of all financial products and their derivatives or unified regulation of stock-related products. Treasury took the position that the minimum change that is needed is to unify the regulation of stocks, stock options, and stock index futures under the SEC. In addition, consolidation of margin authority in a single regulator was proposed, as well as, amendment of the exclusivity provision of the CEA. He ended his

testimony with this warning: "Indeed, we believe that any more limited approach will only delay the resolution of intermarket problems that must be addressed. If this minimum approach cannot be accomplished soon, it seems very likely that we would be forced to adopt a complete merger approach at a later time in response to new major market disruptions."

Given the strong and outspoken position of the Treasury Department on this subject, it was entirely reasonable to expect action to change the jurisdictional boundaries at least along these "minimal" lines.

Hence, it became incumbent upon me, as well as everyone else with the authority to influence or effect a change, to carefully think through the options and draw reasoned conclusions about the best course of action. My experience as a regulator - both at the CFTC and at the SEC -- gives me a very keen appreciation for the day to day impact of jurisdictional confusion and conflict on the internal operations and external relations of the two agencies. My work with brokerage firms at the Futures Industry Association similarly provided a specific understanding of the position that community finds itself to be in as a result of the jurisdictional split. The opinion I have formed is the product of this ten years work and the perspective of having viewed the problem from these three vantage points. It is not simply an imperative of turf or ideology.

In light of the choices laid out by the Treasury, I have said that my preferred alternative would be merger of the

agencies. It is still my preference. My reasons have been reported in the press, but I'd like to review them briefly. If there is to be a change in jurisdiction, I prefer merger to the piecemeal transfer of products from the CFTC to the SEC. Merger, as opposed to the transfer of only one product, can result in economies for brokerage firms and should not increase costs for exchanges. Merger enables the expeditious resolution of intermarket issues. Merger enables the new agency to speak with one voice internationally, and to bring the maximum amount of leverage to bear in international negotiations. Merger would release both the futures and securities industry from the current climate of uncertainty that dominates and hampers the development and introduction of new products. Merger more nearly ensures that the scheme of regulation that recognizes futures as unique instruments will survive. Merger leaves no agency overburdened or stripped of the resources necessary to do the job.

But, there are two issues in this debate that, in my opinion are more important, more timely and in fact, less political than the issue of which agency will regulate stock index futures. Those are federal oversight of stock index futures margin levels -- really, the lack thereof -- and the exclusivity provision of the Commodity Exchange Act.

The exclusivity provision under current judicial interpretation, in brief, provides that a contract which contains elements of futurity must be traded on a futures exchange subject to the exclusive regulatory jurisdiction of the CFTC, and can in

fact, be traded nowhere else. A futures contract can also be a security which, under other circumstances would give the SEC jurisdiction but the jurisdiction of the CFTC is exclusive as to futures. Regardless of however else an instrument might be characterized, it must be regulated by the CFTC and traded on a futures exchange only. The classic, oft-cited case of the exclusivity provision's negative impact on the marketplace is the recent 7th Circuit decision concerning index participations or "IPs". IPs were approved by the SEC for trading on the Amex, CBOE and Philadelphia exchanges. A law suit was initiated by the Chicago futures exchanges, alleging that IPs are futures contracts and therefore must trade only on a CFTC designated futures exchange. The 7th Circuit agreed and IPs trading was halted. Two of the securities exchanges have filed a petition for cert in the Supreme Court.

I don't know whether index participations were good products, and honestly, I don't really care if they were or not - it is not for me to decide the issues of their merit. What I care about is that they never got to really be tested in the marketplace. And I care about creative people having the opportunity to introduce new products and the American public having the opportunity to trade them or not trade them as they see fit. I detest the idea that we have a system in which new products are first subject to the test of litigation before the test of the marketplace and where regulators must waste precious time and tax dollars taking sides.

When you look around the world at the decreasing competitiveness of American industry, you have to conclude that any provision of law which inhibits and discourages innovation, absent a compelling safety and soundness argument, is wrong. It is a luxury we can ill afford. If I can harken back a moment to the beginning of my remarks - lest anyone has been asleep for the past few years, there is competition out there and no segment of American business is invulnerable, including the financial markets. We can all agree that London, Tokyo, Paris, and Toronto are threats to the preeminence of US stock and futures markets. But, countries like Germany, Australia, Switzerland, Mexico, Taiwan, and Thailand, are not going to stay far behind us forever. Whatever we can do to make US markets more attractive, more innovative, more efficient and more liquid, we should be doing. I firmly believe that the exclusivity clause inhibits that process.

As for margin: I know this is heresy to my friends in the futures industry, but I take comfort in sharing this position with Chairman Greenspan. I believe that there should be some greater federal oversight of futures margins. In the first instance I believe the exchanges are the appropriate place to set margin levels. I agree with the Federal Reserve Board that the primary purpose of margins is to protect the clearing organizations, brokers and other intermediaries from credit losses that could jeopardize contract performance. However,

margin levels are too fundamental to the financial integrity of the entire stock, futures and options clearance and settlement system for that process to occur without any federal oversight at all, short of declaring a market emergency. I share the concern that the significant lowering of margin levels during periods of stability and the resultant need to raise them during periods of volatility introduces unnecessary liquidity pressure on the markets, customers and their lenders during times of adversity. I would be pleased to see the Fed take on the responsibility of vetoing levels that it determined were too low.

After all is said and done, what can we expect from the jurisdictional debate? Today the Treasury will introduce a bill to transfer jurisdiction over stock index futures to the SEC from the CFTC, to provide for federal oversight of stock index futures margin levels and to amend the Commodity Exchange Act's exclusivity provision. The bill is called the "Capital Markets Competition, Stability and Fairness Act of 1990". Its purpose is to promote the efficiency, coordination, and stability of the stock and stock derivative markets; to facilitate the development of innovative and economically useful financial products; to enhance the competitiveness of US financial markets; and to foster the trading of innovative financial products. It is an interesting and perhaps novel legislative vehicle because in a wholesale manner, it incorporates the Commodity Exchange Act into Securities Exchange Act and transfers to the SEC the

responsibilities of the CFTC with respect to stock index products and exchanges, brokers, trading advisors, pool operators, futures associations and any person purchasing, selling or advising with regard to stock index products. Stock index products are defined as any contract for sale, or option on such contract, for future delivery of a group or index of equity securities, or any interest therein or based on the value thereof.

The SEC will have full authority to adopt rules concerning the regulation of stock index products. Presumably, different rules for all other futures can be adopted by the CFTC under the same provisions. It is immediately clear that the agencies will need to develop and maintain a high degree of coordination in this process as we run some risk of adopting inconsistent rules with which compliance may be impossible. The drafters recognized this danger, and the Bill explicitly requires the SEC to consider the sufficiency of existing CFTC rules and the views of the CFTC in promulgating any new rules or regulations.

After enactment, any subsequent congressional changes to the CEA will require amendments to the Securities Exchange Act. For purposes of the antifraud prohibitions of the securities laws (section 10b) and related enforcement activity (section 21), stock index products will be defined as "securities". Note that insider trading is a violation of the securities laws under section 10b but that there is no counterpart or similar concept

under the CEA. The Commission will have the ability to engage in rulemaking under 10b concerning manipulative or deceptive practices.

Finally, with respect to the transfer of jurisdiction, the CFTC's customer reparations forum would be available for stock index products but appeals from the determination of an ALJ would be made to the SEC.

Concerning the CFTC's exclusivity clause, the Treasury has chosen to add a new clause to the CFTC's exclusivity provision which creates a broader exemption from the CEA for transactions not done on a futures exchange involving securities, including government securities, foreign currencies, resales of installment loan contracts, repurchase options, mortgage purchase commitments and swaps undertaken by parties in conjunction with their business or risk hedging activities. Thus, swap agreements that might be marketed to the general public would not be exempt. I believe that the Treasury was concerned that the positive steps of standardization of swap agreements, and creation of a margining and clearance system for swaps were being inhibited by the fear that they would be subject to CFTC regulation and forced into an exchange trading environment - or forced off-shore.

The bill also provides the CFTC with the express authority to exempt certain financial instruments from regulation under the CEA if such an exemption would be consistent with the public interest. The intent of this provision is to overrule the 7th Circuit decision in the IPs case so that instruments with both

the characteristics of futures and securities can trade either on futures markets or on securities exchanges.

With regard to margin, the SEC will be given the authority to review, approve or disapprove margins for stock index products.

There are a number of other less momentous and technical changes and transition provisions which provide for continuity for the contract markets (or exchanges) and regulated persons. Further, all orders, rules, regulations, and interpretations, under the CEA, as well as exchange and NFA rules, remain in effect until modified, terminated, set aside, or superseded.

I'm not particularly good at predicting what Congress will do. An informal survey tells me that the chances for passage are perhaps even, although the calendar does not favor such a result. Best guesses are that there are 50 days left in this legislative session. That's a woefully short time to effect a change as momentous as this. More importantly though, this is a highly divisive, emotionally charged issue on Capitol Hill. Whenever the lines of jurisdiction of congressional committees are to be redrawn, you can expect a long and intense debate.

The two issues I care most deeply about are, of course, totally mired in the broader debate about which agency should be responsible for stock index futures regulation. The most unfortunate outcome for the marketplace and the public would be for this year to pass without resolution of at least the issues of exclusivity and margin oversight. I am very afraid that we

will have nothing to show for a year's effort on these two critical issues.

There is of course other jurisdictional legislation already pending on the Hill - Congressmen Glickman and Eckhart have introduced a bill to establish a Markets and Trading Commission in order to combine the functions of the CFTC and the SEC into a single independent regulatory agency. Senator Gorton has also introduced a bill which would transfer jurisdiction over stock index futures to the SEC. Of course, one of the interesting, less well known facts about this process is that while we wallow in the jurisdictional quagmire, other critically important legislation may be held up: the SEC's Remedies Bill, the CFTC Reauthorization, the Market Reform Bill and others. That is not in my opinion, government at its most effective.

I do not mean to minimize in any way the importance of these issues of jurisdiction nor to imply that the strength with which each side holds its views are not genuine and based on an honest belief about what is best for the marketplace. But I do believe there are many, many other important issues to which we need to individually and jointly devote our skill and resources. Sadly, I have to wonder whether others feel as I do, that perhaps we have not made the best use of our time over the past fifteen years engaged in a seemingly never-ending debate on jurisdiction. Certainly, brighter people than I have been consumed by this subject and continue to devote

extraordinary effort and attention to it.

Unfortunately, the debate has, in some regards, become vitriolic and destructive of professional and personal relationships. We have perhaps lost sight of the fact that we are all playing on the same team.

It is my sincerest hope that this process does not destroy us all; that we can learn to work together better, regardless of how this particular episode of the on-going drama is concluded. We have the best futures and securities markets in the world. But that is not our god-given right; it is because we have worked hard and creatively to respond to the needs of American business to raise capital, and to American investors' desire to participate in this nation's economic growth and to the needs of a wide range of industry to hedge their risks and freely and efficiently discover prices. We flirt with the loss of everything we have achieved when we fight among ourselves. The loser in a never-ending battle between our two industries and our two regulators, is quite frankly the American public. We stand to lose to foreign competition the benefits we now reap from having the deepest, most liquid and efficient markets in the world. The potential loss of our financial preeminence presents a challenge that I truly believe is worthy of our tackling together. It is incumbent upon us all to always bear in mind that the stakes are very much higher than our parochial interests might indicate. Thank you.