

Statement of
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Chairman
Commodity Futures Trading Commission
- Before the
Securities Subcommittee of the
Senate Committee on Banking, Housing, and Urban Affairs
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EXECUTIVE SUMMARY

Under the regulation of the Commodity Futures Trading Commission, United States futures markets are the world's largest, most liquid, and most innovative. Our regulatory system is a model imitated worldwide.

Those of us charged with making policy choices must work to sustain fair and open markets, financial integrity, investor confidence, and international competitiveness for all United States markets -- both securities and futures. As we make these choices we must distinguish fact from rhetoric, the goal of international competitiveness from the assertions of competing domestic interests, and distinguish between the different functions served by capital formation and risk-shifting markets.

We are here to discuss proposals that would radically change the current regulatory structure. Three proposals have been discussed publicly: (1) shift stock index futures jurisdiction from the CFTC to the SEC; (2) shift jurisdiction over all financial futures to the SEC; and (3) merge the SEC and the CFTC. The

Commodity Futures Trading Commission opposes any change in CFTC jurisdiction. The Commission does not believe a change in jurisdiction will resolve any of the real issues our markets face today.

Several assertions have been made that appear to motivate the proposals. But careful examination of the assertions shows that they are not supported by significant empirical evidence.

1. Stock index futures and related trading strategies have driven the individual investor from the stock market.

The evidence is clear. Stock index futures are not driving the individual investor from the stock market. Direct stock market participation by individuals is indeed declining, but not because of stock index futures. The decline has been going on for decades and is transforming the financial service industry around the world. The individual investor is still in the market participating through institutions such as pension funds and mutual funds. And the risk associated with investor positions are managed with futures contracts.

2. Trading stock index futures increases stock market volatility.

There is no credible evidence in support of the contention that futures trading contributes to excessive volatility in the cash market. The overwhelming consensus of academic research on this issue concludes that futures trading does not contribute to cash market volatility. In fact several studies indicate that cash market volatility is diminished by the introduction of futures.

3. **Margins on stock index futures are too low and are inconsistent with cash market margins. As a result, market volatility is increased and market declines are exacerbated.**

There is no credible evidence to support the contention that low margins for stock index futures cause stock price volatility. Calls for "harmonization" of margins must recognize the fundamental difference between the futures and securities markets, and the different settlement cycles and components of margin. The Working Group on Financial Markets, less than two years ago, unanimously agreed that for prudential purposes, stock margins must be significantly higher than futures margins to provide the same level of financial protection.

The proof that the futures margining system works well is unequivocal. No clearing member firm defaulted in either October 1987 or October 1989.

4. **Separate regulators cannot effectively police intermarket frontrunning.**

Intermarket frontrunning has been described as trading in one market while in possession of material non-public information about another market. Futures exchanges actively monitor trading patterns for intermarket frontrunning. Despite allegations, there is no concrete evidence that intermarket frontrunning or any other intermarket trading abuse poses a significant threat to market integrity. Potential abuses are being addressed through coordinated monitoring and enforcement efforts within the existing regulatory structure.

5. The existence of two agencies in the United States to regulate securities and futures markets puts us at a disadvantage in international negotiations with the regulators from other major countries, some of whom have a unified system of regulation.

To the world at large, the CFTC and the SEC are regarded as the leading regulators of futures and securities markets, respectively. Our markets have prospered under the current regulatory structure. ^{we} I see no reason to change our system to parallel foreign authorities. In fact, while some other countries' regulators may appear in their organizational charts to have only one agency in charge of securities and futures products, in practice bilateral negotiation often means working with several bureaus or divisions within the same governmental organization.

6. The futures industry and the CFTC stifle innovation, most recently preventing index participation units (IPs) from trading in the United States.

The CFTC's record on encouraging and accommodating innovation in financial products and trading systems is excellent. The United States futures industry has been the leading innovator of financial products, many of which it created within the past 15 years. After fifteen years of growth and development, financial futures and options have transformed the way institutions, including the United States Treasury, manage risk with significant benefits to the participants in these markets.

Since the issue under discussion is shifting jurisdiction to the SEC, it is only appropriate to also examine the record of support for innovation at the SEC. If the CFTC had not been a separate independent agency during the past 15 years, would we have

seen the growth in products that has made the United States the financial futures and options center of the world? It is doubtful. With respect to these financial instruments, the SEC has been less an innovator and more a roadblock.

Recent trends in financial engineering have created new instruments that combine the characteristics of more traditional futures and securities instruments and that serve in varying degrees the functions of these traditional instruments. We fully agree that innovation needs to be encouraged. However, how will a change in jurisdiction guarantee that innovation will flourish? We think the record of the CFTC recounted here makes clear that we have, and will continue to, encourage innovation and will back up our words with action.

In conclusion, the Commission believes that the case for shifting jurisdiction over stock index futures to the SEC or for merging the two agencies simply has not been made. The Commission's position regarding stock index futures jurisdiction is clear. The CFTC should continue to regulate stock index futures. Like all futures, stock index futures require regulation by an experienced and expert agency; but, most importantly, by a price-neutral agency sensitive to the hedging and risk management function of futures.