Chapter 9

The Bifurcated Regulatory Structure

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Chapter 9

The Bifurcated Regulatory Structure

Two Federal agencies regulate the trading of securities and derivative instruments. The Securities and Exchange Commission (SEC) regulates securities, options on securities, and options on indexes of securities; and the Commodity Futures Trading Commission (CFTC) regulates futures and options on futures. (In addition, the Federal Reserve Board and the Department of Treasury have some regulatory responsibilities.) The SEC was created in 1934, the CFTC in 1974. They have roughly similar mandates, but there are also striking differences between them in the details of their legislative authority and operating procedures.[1]

The basic laws creating these two agencies were written 40 years apart, and both were written when some of today's most heavily traded products did not exist. Financial markets and financial institutions are much more interdependent than they were in the past. Derivative products such as stock-index futures and hedging and arbitrage techniques using those products, tie together the performance of securities, futures, and options markets. They are further linked by the interlocking memberships of securities firms active in all of these markets and their clearing organizations.[2]

Frequent recourse to courts for judicial interpretation of the Securities Exchange Act, the Commodities Exchange Act, and related securities laws may be inevitable because this body of law has major financial, economic, and social consequences. But segregated responsibilities for regulating securities, options, and futures give rise to additional legal issues and policy issues especially when they give markets and market participants an incentive to pit one set of regulators against another.

In 1990, there are before the Congress active proposals to change the existing regulatory structure radically-either by merging the two agencies, or by reallocating their jurisdictions and responsibilities.. Such proposals had been made repeatedly in Congress. In May 1990, the Administration recognized that ". . the time has come to reform the disjointed regulation of the markets governing stocks, stock options, and stock-index futures. '

The danger in a failure to act, an Administration spokesman said, is that "we are now more likely to see minor events trigger major market disruptions. . ..' This would risk "the entire financial system, especially through the clearance and settlement process. . .."

Relations between the two agencies, at the working level, appear to range from cordial cooperation to polite teeth-gritting. Recurring jurisdictional struggles over new exchange products highlight one serious problem in the current regulatory structure. A more critical weakness is the ad hoc nature-and thus the basic uncertainty-of the coordination of safeguards against dangerous volatility and stress, across financial markets that are increasingly linked by technology, products, and hedging and arbitrage strategies. The two regulatory agencies take different positions on the possible causes of market volatility, how much volatility is dangerous, and what measures are justifiable as preventatives. While the interactions of linked markets are probably not fully understood, the implications of this linkage have become highly controversial and highly politicized because they affect both extremely profitable activities in the private sector and the distribution of responsibility and power in the public sector. This makes it less likely that the agencies will always be able to act with dispassion, speed, and coordination in emergencies.

[1]The SEC is nearly four times as large as the CFTC. The SEC has approximately 2,200 people and a budget of $168.7 million for FY 1990, with a 1991 budget authority of $177 million (the President requested $192.4 million and 2,375 staff years). The CFTC has 1990 budget of $37.18 million and a staff of 529, with a presidential request for $44.96 million and 595 people in 1991, and projected congressional authority for $40 million.

[2]According t. the CFTC, 12 firms are clearing members of both futures and stock clearing organizations; 20 firms are clearing members Of futures and securities options clearing organizations. These 32 firms with interlocking memberships are only 3 percent of all clearing firms (963), but are probably among the largest.

[3]Statement of the Honorable Robert R. Glauber, Under Secretary of the Treasury for Finance, before the U.S. Senate Committee On Agriculture, Nutrition, and Forestry, May 8, 1990.

REGULATION OF SECURITIES MARKETS

Until 1934 secondary securities markets were subject only to U.S. postal laws (as are all businesses) and to State civil and criminal laws. The Securities Exchange Act of 1934 (and the Commodities Exchange Act 2 years later) reflected public outrage over perceived causes of the 1929 market crash: excessive speculation and market manipulation. The Securities Exchange Act (SEA) emphasized congressional determination to prevent 'inequitable and unfair practices' in stock exchanges and the over-the-counter (OTC) market.

The Act created the Securities and Exchange Commission[4] as an independent regulatory agency. The new agency was to regulate the practices of dealers and brokers in both formal and OTC markets,[5] and to make sure that the public is given information about publicly traded securities. The law prohibited the use of corporate information and news by "insiders" for trading advantage. It also provided a framework for controlling the amount of speculative credit that may be extended to market participants, but this authority-to set minimum levels of "margin"—was given to the Federal Reserve Board rather than the SEC, since it was considered to affect broader policies of credit control.

Much of the basic regulatory responsibility was left to the exchanges, as self-regulatory organizations, or SROs. (The National Association of Securities Dealers, NASD, was created 5 years later as an SRO for the over-the-counter market.) Within limits defined by Federal and State statutes, SROs draw up their own rules and have the authority to censure, fine, suspend, or expel both their members and their employees. SROs also register securities account executives and investment brokers.[6]

There are significant costs involved in carrying out self-regulatory functions. The New York Stock Exchange (NYSE) says that 22 percent of its revenues and 29 percent of its staff are allocated to regulatory activities, including surveillance and enforcement.[7] The NASD says that in fiscal year 1990, 81 percent of its $111 million budget was allocated to regulatory functions.

States retained some securities regulatory powers. State commercial laws in conjunction with Federal securities laws and bankruptcy laws affect many aspects of securities transactions, especially clearing and settlement and the obligations of various market participants. Securities must be registered in every State in which they are sold, as well as with the SEC. (Some States now provide for "registration by coordination, " i.e., by proof of SEC registration.) There are differences among the States in the scope and details of securities regulation, but most States are actively concerned with protection of the individual investor against fraud and manipulation by retail brokers.

The 1934 Securities Exchange Act's consumer protection clauses tried to shield investors against dishonesty, but not incompetence, on the part of brokers. That was considered the responsibility of the SROs. For example, the NYSE and NASD could intervene in the affairs of their member firms to transfer customer accounts and positions to stronger members, to liquidate failing members, or to effect mergers with healthier firms.[8] In the 1960s, however, the growing volume of trading and the ''back-office' (paperwork) overload strained the financial capacity of many brokerage firms. Congress created the Securities Investors Protection Corp. (SIPC) in 1970, to protect customer accounts up to certain limits against failures of securities fins. The SIPC funds are provided by annual assessments of exchange-member firms.[9]

[4]The SEC is governed by five commissioners, with no more than three from one party, appointed by the President with the consent of the Senate.

[5]Federal, State, and municipal bonds and some other kinds of securities are exempt from most provisions of the Act, but they are subject to the antifraud provisions, as are all securities.

[6]They now require a several month training program and examinations before registration.

[7]In 1989, NYSE regulatory expenses were $78.6 million. Revenues from operations and short-term investments were $349.3 million. There were 1,977 on staff, of which 579 were assigned to regulatory functions. Figures provided by the NYSE.

[8]Between 1968 and 198(1 the NYSE had to expend $61 million from its Special Trust Fund to liquidate or merge troubled member firms. See Richard J. Teweles and Edward S. Bradley, *The Stock Market,* 5th ed. (New York, NY: John Wiley& Sons, 1987), pp. 317-320.

[9]SIPC also has emergency borrowing lines to the Federal Reserve giving it resources of over $1 billion, and most brokerage firms also have SOme commercial insurance. Nevertheless, it is not at all certain that SIPC could handle the failure of a major firm, which might have more than 250,000 accounts. The largest failure yet handled by SIPC involved fewer than 33,000 accounts. Many people in the securities industy appear to believe that the Federal government would "bail out" any major securities firm that failed, even though there was no bail out of Drexel Burnham Lambert in 1989.

REGULATION OF FUTURES MARKETS

Regulation of the futures market began with the Grain Futures Trading Act of 1922, with responsibility lodged in the U.S. Department of Agriculture until 1974 (see ch. 4). The present regime was established with the Commodity Futures Trading Commission Act of 1974 (88 Stat. 1389). The Act provides that a new Commodity Futures Trading Commission ". . . shall have exclusive jurisdiction with respect to . . transactions involving. . . contracts of sale (and options on such contracts) for future delivery . . .." It is to administer the basic provisions of the Commodity Exchange Act of 1936. The new 1974 Act defined "commodity" to include not only agricultural staples and other "physicals," but also "services, rights, and interests in which contracts for future delivery are presently or in the future dealt in. . .," thereby expanding the term to include many financial instruments. The CFTC was created under ''sunset legislation, ' a popular concept in the early 1970s, which provided that the agency would cease to exist unless re-authorized periodically. Congressional oversight of the CFTC continues to be exercised by the House and Senate Committees on Agriculture.

CFTC authority generally preempts that of States, although the Commodity Exchange Act (sec. 6D) permits States to prosecute commodities fraud. The SEC's authority is shared with States. The authority of the two agencies also differs in terms of investor protection.[10]

TENSION BETWEEN THE AGENCIES

In 1978, SEC asserted jurisdiction over securities-related activities, including the trading of futures and options contracts based on stocks or stock prices, and sought congressional codification. The congressional Agriculture Committees, however, wanted to keep jurisdiction over all futures trading in one agency.

The linkages between stock and futures markets were not so visible in 1974 and 1978 as they are now. The most direct link-stock-index futures-did not then exist. Nevertheless, some congressional members saw potential problems. The Futures Trading Act of 1982 reflected congressional concerns about the impact of trading in futures contracts on other financial markets. These concerns were stimulated by the Hunt silver scandal and the impending introduction of interest-rate futures. The 1982 Act directed the Federal Reserve Board of Governors (FRB), SEC, and CFTC to assess the effects of futures and options on capital formation, the liquidity of credit markets, the adequacy of customer protection, the effectiveness of regulatory tools and mechanisms, and the extent to which futures contracts could be used to manipulate markets and prices. The study concluded that futures and options did not have adverse effects on capital formation or stock and credit markets.

Over time most of the early congressional concerns about trading in futures contracts were allayed through this and other studies by Federal agencies and through a growing body of practical experience. This unease was roused again in 1987 and 1989 by the possibility that stock-index futures and related trading behavior contributed to-or caused-market breaks (see ch. 4). The bifurcated regulatory structure itself has become a focus of concern and controversy. It is particularly controversial in terms of: 1) the effects on innovative financial products, 2) the setting of margin requirements, and 3) decisions about measures to be taken when markets are stressed or collapsing.

INNOVATION AND REGULATION

The boundary between SEC and CFTC jurisdiction is, in broad terms, that between instruments for capital formation (securities) and instruments providing a means of hedging, speculation, and price discovery without the transfer of capital. Options are sometimes regarded as an investment, but more often as an instrument for hedging or speculation. The SEC has authority to regulate trading of options on securities. The CFTC regulates trading of futures contracts (including futures on stock indexes) and options on futures contracts. The CFTC has jurisdiction over options on foreign currencies-except

[10]For example, the CFTC performs direct market surveillance based on large trader reporting, which the SEC cannot yet require (a bill that would authorize the SEC to require large traders to report their transactions is now before Congress). As another example, the CEA requires futures commission merchants (the firms that handle purchase and sale of futures contracts for retail customers) to segregate customers funds. SEC Rule 15c3-3 requires segregation only of net total credits, but the Securities Investor Protection Act setup an insurance fund for further investor protection.

when the option is traded on a national securities exchange, in which case the SEC has jurisdiction. Thus the SEC regulates an option on the British pound traded by the Philadelphia Stock Exchange, and the CFTC regulates essentially the same option traded at the Chicago Mercantile Exchange.

Futures exchanges have been highly innovative in developing new products, and the CFTC has generally been responsive and flexible in approving those products (or in agreeing to exclude them from regulation). The SEC has until recently been more cautious in approving new exchange products.[11]

But the futures exchanges' innovative products have blurred the distinctions assumed in statutes, and thus the allocation of responsibility of the CFTC and SEC, particularly with the advent of products whose definition and price are derivative of products traded on a securities exchange. In drawing up the Securities Exchange Act of 1934 and the Commodity Exchange Act of 1936, legislators could not anticipate the new products and computerized trading strategies that would eventually confront regulators. As a result, the two agencies have frequently struggled with jurisdictional confusion, sometimes resolved by negotiation but sometimes finally resorting to courts to sort out jurisdictional disputes. In time, the related industries have come to use the threat of litigation to thwart competition and perhaps to thwart regulation as well.

A major source of difficulty is the "exclusive jurisdiction' phrase in the Commodity Futures Trading Commission Act. The Act says:

> .. the Commission [CFTC] shall have exclusive jurisdiction with respect to. . transactions involving . . .contracts of sale (and options on such contracts) for future delivery of a group or index of securities (or any interest therein or based on the value thereof) .[12]

Most new contracts, if they are not standard corporate stock or bonds, have some aspects of "future delivery," and the likelihood that they will be found by the courts to fall under the CFTC's jurisdiction may effectively discourage stock markets from product innovation.

Exchanges have formed separate subsidiary exchanges in order to avoid being regulated by both the CFTC and the SEC. The NYSE formed the New York Futures Exchange and the Philadelphia Stock Exchange formed the Philadelphia Board of Trade. Futures exchanges are particularly intent on avoiding regulation by the SEC, saying that it does not understand futures trading.

Serious disagreements erupted between exchanges seeking to innovate, and between the regulatory agencies, over products at the intersection of the agencies' jurisdictions.[13] In 1981, the chairmen of the SEC and the CFTC entered into an agreement clarifying the respective jurisdictional responsibilities of the two agencies, pending the enactment of clarifying amendments to the securities and commodities laws.[14] This Shad-Johnson agreement (named after the two chairmen) left the CFTC exclusive jurisdiction over futures contracts and options on futures contracts. It recognized SEC as sole Federal regulator of options on securities and on foreign currencies traded on national securities exchanges. The agreement specified certain criteria that the CFTC would use in approving futures contracts on a group or index of municipal and non-exempt securities.[15]

As part of the Futures Trading Act of 1982, Congress enacted the Shad-Johnson agreement into

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[11] Thomas Russo, who practices securities and commodities law as a partner in Cadwalader, WickerSham & Taft, told Congress: "AS a result of the recent-and in my view unfortunate—Seventh Circuit decision in the IPS case, the Commodity Exchange Act has become a major obstacle to product innovation. . . The IPS decision will work, in effect, to ban many new products with any element of futurity from the U.S. markets."

[12] 7 U.S.C. 2a(ii). See also 7 U.S.C. *Section* 2 . . . "the Commission shall have exclusive jurisdiction, except to the extent otherwise provided in sec. 2a of this title." U.S. Court of Appeals for the Seventh Circuit, *CME et al., v. SEC,* decided Aug. 18, 1989.

[13] For example, in early 1981, the SEC gave approval for the CBOE to trade options on Government National Mortgage Association securities. The CBOT (which had traded GNMA futures since 1975) objected. The U.S. Court of Appeals of the Seventh Circuit ruled that the SEC was without jurisdiction because of the exclusive jurisdiction clause in the CFTC statute. Board of Trade of City of Chicago v. SEC, 677 F,2nd 1137, 1142 n.8, 1156-1158 (7th Cir. 1982), *vacated as moot, 459* U.S. 1026 (1982). The Court said that GNMA options were not securities, despite a "right to . . . purchase" phrase in the securities laws.

[14] SEC and CFTC press release Dec. 7, 1981, 2982-82 Fed. Sec. L. Rep. (CCH) Par. 83,062.

[15] The Seventh Circuit Court later ruled that the SEC and CFTC could not alter their jurisdiction by mutual agreement. See 677 F.2d at 1142 n.8. The jurisdictional dispute between the CFTC and SEC was over options on GNMA certificates. An appeals court later found them to be "both securities and futures," and, therefore, "the CFTC's jurisdiction is exclusive in light of 7 U.S.C. Sections 2 and 2a. " U.S. Court of Appeals for the Seventh Circuit decision in *CME et al., v. SEC,* Aug. 18, 1989, pp. 11-12.

law. Congress added a provision that the SEC had the right to object to a futures contract on a stock index (or option on such a contract). After a hearing, SEC's objection could be taken to judicial review.[16]

In late 1983, the SEC objected to four stock-index futures contracts proposed by the Chicago Mercantile Exchange (CME) (based on indices of sectors of the securities markets such as energy corporation stocks or financial institution stocks). This led to a second agreement between the two agencies setting out detailed guidelines for joint CFTC/SEC approval for index futures contracts and options on index futures contracts. Subsequently, there was joint approval of 20 stock-index futures contracts, later withdrawn. In May 1988, in the wake of the crash, the SEC Commissioners again voted to propose the transfer to the SEC of CFTC jurisdiction over stock-index futures contracts and associated options.[17] This has been proposed anew in 1990.

In 1989, the continuing dispute focused on jurisdiction over a new financial instrument called Equity Index Participations (IPs), proposed for trading by three securities exchanges.[18] IPs were to represent "a present interest in the current value of a portfolio of stocks. ' The holder of an IP would be entitled to a proportionate share of an amount equal to any regular cash dividends paid on the stocks in the portfolio, without ever owning the stocks.[19]

Index participations were approved by the SEC as a way to let individual investors get some of the risk-reduction benefits that institutions get from program trading, and as a means to reduce market disruptions due to such high volume trading techniques. They were held by the SEC to be ' 'securities" because their economic function was equivalent to that of securities-a claim to dividends, freely transferable in exchange transactions, and able to appreciate in value. The Chicago Board of Trade (CBOT), the CME, and the CFTC challenged the SEC's approval, claiming that IPs were futures contracts because they represented a transaction that would be cashed out at a future date, at a price based on the difference between an initial price and an undetermined future price. The Court of Appeals for the Seventh Circuit noted that the IPs have some of the characteristics of a security and some of the characteristics of a future contract, but because of the exclusivity rule would have to be regulated by the CFTC.[20]

The dispute over regulatory jurisdiction for IPs highlights some useful insights about competing regulators and the stresses that some new innovative products place on the jurisdictional boundaries established by law. Exchanges may seek to protect their existing products against competition from a new financial product that would trade on other exchanges. Regulators must implement statutes as written (but also may seek to protector expand their jurisdiction). These disputes often delay or prevent the trading of new financial products that could be useful to investors.[21]

The dispute over regulatory jurisdiction of IPs also highlights the growing difficulty of categorizing some new financial instruments as either stock, options, or futures contracts and thus assigning their regulation to the SEC or the CFTC. The Appeals Court, unable to find a clear categorization of IPs, complained: ''We must decide whether tetrahedrons belong in square or round holes."[22] The court necessarily relied on interpretation of existing statutes and prior case law, and properly made no

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[16]The Seventh Circuit decision concerning options o, GNMA securities (see footnote 15) was mooted by this legislation (and was also vacated as moot by the Supreme Court).

[17]The vote was, however, 3-2, and Chairman Ruder, who proposed the change, admitted that there was little chance the proposal would succeed (David A. Vise, "Battling for Market Control: SEC, Led by Ruder, Votes To Ask Congress for Index Futures Role," *Washington Post*, May 27, 1988, D1).

[18]They were first designed b, the Philadelphia Stock Exchange, which in February 1988 applied to the SEC for permission to trade them. The AMEX and CBOE later submitted to the SEC their own proposals for variations of IPs.

[19]The IP was to be of indefinite duration. The holder could either exercise a ''cash-out'' privilege available daily or quarterly (this varied among the IPs) or could enter into an "offsetting" sale or purchase to close out his position. In that case, the holder would make a profit (or limit his loss) by receiving or making payment of the difference between the prices of his opening and closing transactions. SEC Release 34-26709, Apr. 11, 1989.

[20]U.S. Court of Appeals for the Seventh Circuit decision in Chicago Mercantile Exchange, Board of Trade of the City of Chicago, and Investment Company Institute. Securities and Exchange Commission decided Aug. 18,1989. Also, "Court Rules SEC Erred in Decisions on Futures Markets," *Wall Street Journal*, Aug. 21, 1989, p. C9.

[21]According t. Thomas Russo, securities and commodities lawyer, the SEC initially rejected the first financial futures contract, which was then approved by the CFTC and traded on CBOT. The SEC also would not approve the first attempts to develop index products. Russo, Op. cit., footnote 11, p. 3.

[22]Ibid., p.2. [7th Cir. Court of Appeals, Aug. 18,1989.]

judgment as to which agency is better equipped to supervise trading in IPs. Nor did this court decision—or earlier judicial decisions, the Shad-Johnson Agreement, or the legislation based on it—resolve the fundamental issue of how to assign jurisdiction for new financial instruments which do not fall neatly within either the capital formation or the hedging categories.

MARGIN REQUIREMENTS

In stock markets, "margin" is the amount that, under FRB rules, brokers, dealers, and other lenders must require from customers as a down payment when they sell securities to customers on credit. Exchanges and the NASD also require additional "maintenance margin" deposits.[23] In futures markets, margin is defined as a performance bond that protects the clearinghouse against default by clearing members. Proposals have been made repeatedly to "harmonize' the levels of margins across markets—generally with the policy objective of raising futures margin requirements in order to constrain the pressure that might be transmitted from futures markets to stock markets. This issue is discussed in chapter 4. It is closely related to another policy issue: How and by whom should margin levels be set?

After the 1929 stock market crash, Congress concluded that low margins required for stock purchases had encouraged excessive speculation. Margin requirements were, at the time, set by stock exchanges without government intervention. The FRB was empowered by the 1934 Securities Exchange Act to specify required margin levels on securities.

The FRB changed stock market initial margin requirements 15 times from 1934 to 1959 and less frequently thereafter. Since 1974 it has left initial margin requirements at 50 percent of the market value of purchased stocks, and 150 percent of the value in ''short' transactions.[24] The stock exchanges and NASD'S additional maintenance margins require at least 25 percent of market value in long transactions.[25] Specialists and OTC market-makers pay much lower margins.

Futures margins are set by exchanges and are usually about 5 percent. Only in emergencies does the CFTC have authority to direct the exchanges to raise margins. Unlike stock margins, required levels for futures margins change frequently. For a time following the 1987 crash-possibly to ward off the numerous proposals that Congress take action to require higher futures margins[26]-exchanges did not drop this requirement below 15 percent for speculative long or short positions, but the requirement was soon halved. In early May 1989, the CME reduced the speculative margin for S&P 500 futures from $15,000 to $6,500. In October 1989, it varied from $9,000 to $12,000-FRB Chairman Alan Greenspan later said that he was shaken by the exchange's action in raising margin requirements during the market break, because it drained liquidity from the market when it was most needed. In May 1990 the margin requirement stood at $20,000.

The inability of empirical studies to answer decisively (at least to the satisfaction of all sides in this politicized argument) the question of whether initial margin requirements affect volatility is discussed in chapter 4. Regardless of empirical research, the regulatory agencies take strong-and conflicting-stands on this question. SEC's Division of Market Regulation 'continues to believe that low futures margins have contributed to the size and volatility of short-term market movements, ' '[27] and Richard Breeden, chairman of the Commission, has on several occasions in 1990 reiterated a demand for

[23] When an adverse market movement has reduced the margin account to a point where the cash or collateral loaned to the account holder by the broker is jeopardized, the exchanges require the customer to deposit additional equity, or "maintenance margin." If a customer buys stock worth $100, he might put up $50 (initial margin) and borrow $50. Unless the stock value falls below $66.67, the customer would not need to deposit additional maintenance margin because the remaining value of the stock to the customer ($66.67 minus the $50 he put up) is $16.66, which is equal to the NYSE's maintenance margin requirement of 25 percent of $66.67. If the value continues to decline more maintenance margin will be demanded.

[24] In a short transaction, one is selling stock that one does not yet own, but has borrowed, expecting to be able to buy it subsequently at a lower price.

[25] In options trading the margin is a performance bond to cover the obligations incurred if the underlying stock generates a loss for the options writer. FRB has deferred the setting of both initial and maintenance margin to the options exchanges subject to SEC oversight. The way these are set was explained in ch. 5. That chapter also discusses the related issues of cross-margining and futures-style margins for options.

[26] The President's Task Force on Market Mechanisms, as one example, called for margins in the two market segments to reflect roughly equivalent risk and leverage.

[27] Richard G. Ketchum, Division Director, in a memorandum to SEC Director David S. Ruder, June 30, 1989, p. 22.

higher margins.[28] CFTC Chairman Wendy Gramm told Congress in March 1990, “There is no credible evidence to support the contention that low margins for stock-index futures cause stock price volatility.“2[9] Secretary of Treasury Brady has called for higher margins. Alan Greenspan, chairman of the FRB, says, “Although available statistical evidence on the relationship between margins and stock price volatility is mixed, the preponderance of the evidence is that neither margins in the cash markets nor in the futures markets have affected volatility in any measurable reamer. ’

After the 1987 crash, there were many proposals to change the locus of responsibility for setting margin requirements. (The assumption is that the SEC, and possibly but not surely the FRB, would be likely to raise futures margin requirements, the CFTC-as now constituted-would not.) The President’s Working Group on Financial Markets could not reach consensus on who should set margin levels (reflecting the diverse institutional representation in the Group) .30 Representatives of the SEC, FRB, and Treasury Department argued that the government should set (or disapprove) margin levels for all products. The CFTC, possibly unwilling to be put in a potentially adversarial position vis-a-vis the futures industries, maintains that exchanges are in the best position to assess market volatility and determine appropriate margin levels, with the CFTC having authority to act only in emergency. The SEC in July 1988 proposed to Congress a restructuring of margin regulation. The CFTC would be required to review futures margins to assure that they are ‘‘prudential’ and SEC would have the same responsibility vis-a'-vis securities margin requirements. The FRB would have residual authority to review margin requirements for all products. At one time the FRB asserted that it has power to set margins on stock-index futures, but the FRB has recently shown no interest in exercising this untested claim.[31] It has not changed securities margins at all since 1974, which can be interpreted to mean that it has seen no useful economic purpose served by margin regulation.

In part, this disagreement turns on the question of the purpose of margins. The futures industry (and the CFTC) say that margins are to protect the clearing organization and the futures markets against default of a clearing member. Because of the practice of marking-to-market daily, and daily or intra-daily margin calls, relatively low initial margins afford fully adequate protection for the clearinghouse. The argument for government responsibility, on the other hand, makes two points. First, the links between markets now allow participants with great leverage in the futures market to make great demands on the liquidity of securities markets. This creates the opportunity for a financial “tragedy of the commons. ” Secondly, participants in futures markets also are participants in securities and options markets; the collapse of their financial integrity would threaten far more than other clearinghouse members and could imperil basic U.S. financial mechanisms. The question of whether margin requirements are “adequate” must turn on whether ‘‘adequate’ refers to protection of the clearing organization against the potential insolvency of a clearing member, or to the integrity of the clearing and settlement system, or to the robustness of the national payment system.

The SEC and the CFTC continue to make significantly different judgments about the effects of margin levels and about how they should be set. Neither now has the statutory authority to determine margin levels in either market. The CFTC can act in an emergency, but since it holds that margin levels do not affect volatility it would presumably not do so in the context of a market break. The FRB has delegated authority to approve margins on equity options to the SEC.

The unease about the possible affects of low margins for stock-index futures, which increase the leverage that futures market speculators can exert on stock prices, contributes to the controversial propos-

[28]In February 1988, the SEC had suggested that the futures markets should increase initial margins for stock-index futures to a level Of 20-25 percent. “Black Monday-the Stock Market Crash of Oct. 19, 1987,” Hearings before the Senate Committee on Banking, Housing, and Urban Affairs, 100th Cong., 2d sess., 1988,547. Feb. 2,3,4,5, 1988.

[29]Statement of Dr. Wendy L.Gramm before the Senate Committee on Banking, Housing, and UrbarAffairs, Mar. 29, 1990.

[30]It was composed of George D. Gould, Department of Treasury Under Secretary for Finance; Alan Greenspan, Chairma nof the FRB; Wendy Gramm, Chairman of the CFTC; David S. Ruder, Chairman of the SEC.

[31]Markham and Stephanz, ‘‘The Stock Market Crash of 1987—The United States Looks at New Recommendations, ” Georgetown *Law Journal*, vol. 76, 1980, pp. 1993,3037, and n.280.

als to transfer jurisdiction over stock-index futures trading to the SEC. In that case, their margin requirements would presumably fall under the jurisdiction of the FRB. The FRB's responsibility is the financial system as a whole, while there is no reason to believe that any single exchange has the motivation or the ability to fully consider the impacts of its actions on other exchanges and clearance systems or on the economy as a whole.

REGULATORY RELATIONSHIPS

A proposed bill[32] partially addresses concerns about lack of coordination in market regulation. It has four parts: 1) emergency powers for the SEC at times of great marketstress;332) reporting of trades by large traders to allow better investigation of insider trading and better analysis of the effects of institutionalization and program trading; 3) risk assessment;[34] and 4) coordinated clearing mechanisms. In Hearings on this bill held in May 1989, Senator Christopher Dodd listed other congressional concerns: whether margin levels in derivative products markets are high enough to control speculation whether margin harmonization across markets is desirable; inter-market coordination; and "what should we be doing now to prepare for the markets of the future?"[35]

From the time of the 1987 crash until late 1989, staff of both the SEC and the CFTC publicly said that relationships between the two organizations were good, 'that satisfactory ways of sharing information and discussing interagency problems are well worked out, and that the two staff groups continually communicate, both formally and informally. However, the CFTC said that during the 1987 crash ''interindustry coordination could have been better,'' as to whether trading in individual stocks would be halted or whether (as rumored at one time) the NYSE would close. Since the crash, arrangements for coordinated circuit breakers have been put in place.

The SEC and CFTC reach significantly different conclusions in analyzing the causes and contributing factors in recent market breaks. This was evident in their reports on the 1987 market crash, as discussed in chapters 3 and 4. It was evident again in their analyses of market events on October 13 to 16, 1989, both released in May 1990.[36]

In spite of close communications, there is room for disquiet about the effectiveness of coordination in times of emergency because of the differences in approach apparent in these reports. Many of the findings about events, and about similarities and differences compared to events in 1987, are basically the same, but their interpretation and the action implications are quite different.

After exhaustive analysis of trading data from October 13 and October 16, the SEC said that its findings confirmed that "while activities in the index futures market do not, in themselves, cause the sharp market downturns or price rises . . . these trading strategies, in particular index arbitrage, can markedly accelerate price movements already underway." The CFTC found that "Neither program trading nor futures sales by those with large positions, explain the observed price movements on those days. " The CFTC did find that stock-index futures markets "initially reacted faster than their underlying stock indices when market-wide volatility increased' but there was no evidence of causation.

The SEC noted that the partial circuit breakers that took effect in futures markets coincided with a sharp drop-off in program selling and a reduction in the rate of price decline in stocks. The SEC said that "while a direct causal relationship is difficult to establish, " at a minimum its findings indicate "an absence of harm' from the imposition of price limits. The CFTC also said it was "difficult to draw conclusions from limited observations" but found that ''shock absorbers do not appear to have

[32]''Market Reform Act of 1989'' (S.648), and "Stock Market Reform Act of 1989" (H. R.1609), later H.R. 3657.

[33]The original proposed Act would expand SEC emergency powers to call a halt to securities trading under certain conditions; a later proposed version requires Presidential approval before closing markets. The CFTC already has such emergency powers over futures trading. Hearings on S.648, The Market Reform Act of 1989, May 18, 1989.

[34]The Market Reform Act also would allow the SEC to gather data to assess the financial soundness of holding companies that own broker-dealer firms ("risk assessment"). The NYSE, supporting this proposal, remarked that "As financial institutions enter non-traditional businesses not subject to self-regulatory oversight, they have the potential to create systemic risks domestically and internationally. "

[35]Senator Dodd's opening statement, Hearing on S. 648, The Market Reform Act of 1989, May 18, 1989.

[36]Commodity Futures Trading Commission, Division of Economic Analyis, *Report on Stock Index Futures and Cash Market Activity During October 1989, May 1990. Securities* and Exchange Commission Division of Market Regulation *Trading Analysis of October 13 and 16, 1989, May* 1990.

moderated intraday market volatility,' and that "instead, there is some evidence that a binding circuit breaker in one market is associated with increased volatility in other unconstrained markets.' The CFTC model predicted that stock market volatility would have been higher if the futures price limit had remained in effect longer.

With the present informal arrangement for cooperation between these two agencies, there is always a risk-even a probability-that new areas of conflict will arise. Further conflict is likely to arise for the same reasons as past conflict, through continued disputes about jurisdiction over new instruments, disagreements over different margin levels, and finger-pointing when there is another sharp market decline. These disputes raise the question of whether a different regulatory structure is now needed, to avoid a continuation of tensions between regulators.

Three approaches to permanently resolving the jurisdictional issue are possible: 1) provide clearer jurisdictional separation for each agency; 2) create an inter-market coordinating committee or agency; and 3) merge the SEC and CFTC to create a new agency.

Clearer Definition of Jurisdictions

Earlier efforts toward redefinition of jurisdictions have not proved effective. It is almost impossible to foresee just what attributes tomorrow's financial products will have because "new instruments can appear at any border. ' '[37]

One approach is to assign jurisdiction on the basis of the primary function of each financial instrument (i.e., capital formation instruments v. risk shifting, hedging, or speculation instruments). Regulatory jurisdiction over options could be transferred from the SEC to the CFTC. Instruments that provide both capital formation and risk shifting functions (to different investors) would still pose problems.

Alternatively, jurisdictional responsibility might be assigned according to whether the purchaser owns or does not own the assets underlying the instrument. This would make the CFTC responsible for all options and all futures, the SEC would have jurisdiction over capital raising instruments—stocks, bonds, and also commodity pools.[38]

It would almost certainly be necessary to increase the size of the CFTC with either of these approaches. Neither would solve the problems of assigning responsibility for subsequent new products, of determining appropriate futures margin levels, or of coordination in emergencies.

A third approach would place all products whose price is directly derived from stock prices-such as stock-index futures and stock-index options-under SEC. This would leave a mixed bag of financial futures contracts to be regulated by the CFTC. Alternatively, all financial futures could be shifted, so that the CFTC retains only futures contracts based on agricultural products, industrial materials, metals, etc., i.e., non-financial contracts. Under this approach the jurisdictional assignments would cut across market institutions, trading location and exchange responsibility, trading techniques, margining systems, and retail distribution systems. This could be the source of much complication and confusion.

The possible effects of reassigning stock-index futures to SEC responsibility are uncertain. Whether the exchanges would continue trading these contracts, whether they would be used by the same market participants and in what ways, whether they would be traded overseas, and other such questions have not been thoroughly assessed by those on either side of the controversy. Several gains in efficiency might be achieved if this jurisdiction is transferred to the SEC. For example, the current relationship requires much duplication of effort in joint approval of new products.

Transferring stock-index futures and options on stock-index futures from the CFTC to the SEC would require amendment of Federal securities laws and the Commodity Exchange Act. Existing securities legislation is highly complex, with at least six laws applying to securities markets. Thomas Russo, who practices securities and commodities law and has been a member of the staffs of both the CFTC

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[37]U.S. Court of Appeals, op. cit., footnote 12, p. 13.

[38]Ownership of a commodity pool is much like ownership of a mutual fund in that investors have an interest in the resets of the pool, rather than direct ownership of its assets. These pools acquire various types of futures, e.g., futures on stock indexes, wheat, or gold. The SEC does not now have this regulatory responsibility.

and the SEC, recently told a congressional committee:[39]

> (N)either the commodities nor the securities laws. . . reflect today's markets. When we talk about what we should do with the commodities and securities regulatory structures, we must keep open the possibility that both structures should change. It may well be that neither particularly suits the world in which we live.

A compromise proposal, also in discussion in Congress (in July 1990) would allow the CFTC to retain its authority over stock-index futures and give the SEC authority to regulate any new instruments that "share the qualities of both a future and a stock. " This would not solve the current problems of jurisdictional confusion, margin levels, or control of short term volatility, and it would almost surely give rise to new disputes over subsequent product innovations.

An Inter-Market Coordination Agency

The Brady Commission, in its most controversial proposal, urged that one agency be given the authority to coordinate "a few but critical" inter-market regulatory issues such as clearing and credit mechanisms, margin requirements, and circuit breakers, leaving intra-market issues with either the SEC or the CFTC.[40] Later, the experts behind the Brady report effectively retreated from this suggestion for a two-tier structure.[41] A bipartisan group of Senators proposed an inter-market coordinating committee consisting of the heads of the FRB, the SEC, and the CFTC, but the proposal did not bear fruit.[42]

Placing the authority for jurisdictional decisions in the hands of a multiagency panel could reduce the present reliance on judicial decisionmaking, provided the panel were given clear and binding decisionmaking authority rather than being charged merely with making recommendations. The panel might, for example, be composed of representatives of the SEC, the CFTC, the Treasury Department, and the Federal Reserve Board, with or without representation for SROs; or it might be made up of neutral experts in finance and securities law. The former alternative already exists, in the form of the President's Working Group on Markets. The weakness of this proposal is that on such a panel—which is not an independent, staffed agency—agency representatives vote their agency position, derived from broader agency concerns not always directly focused on the issue at hand. They predictably vote to buttress the authority of their agency, so that most decisions would depend solely on the vote of the third member. If SROs were included they would vote their competitive interests, so that nothing approaching an objective consensus could be expected.

The alternative, an expert extra-governmental panel, would be in a better position to take into account product design and function, the best interests of investors, the efficiency of markets, and other national interests. In practice, however, it would be difficult to find truly neutral experts. The relatively few people with great knowledge and understanding of securities and derivative product markets usually have been affiliated in the past with one set of markets or the other, but not both, as an exchange member or officer, a regulator, or a long-time consultant.

Inter-market coordination primarily involves three tasks: 1) assuring the willingness and ability of the banking system to make credit available to stock brokers, futures commission merchants, and clearing corporations when markets are under stress; 2) margin harmonization; and 3) coordination on issues such as circuit breakers, information sharing, market surveillance and enforcement, and contingency planning. The frost task is already vested in the FRB and was exercised appropriately in October 1987. The

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[39] Thomas A. Russo, Testimony before the Subcommittee on Telecommunications and Finance, House Committee on Energy and Commerce, May 3, 1990. Mr. Russo is a partner at Cadwalader, Wickersham & Taft.

[40] *The Presidential Task Force on Market Mechanisms*, (Brady Report, January 1988, p. 59).

[41] The Brady Report also suggested that the Federal Reserve Board was best qualified to be the inter-market regulatory agency. A month later FRB Chairman Greenspan objected, on the grounds that: a) this would lead to a presumption that the Federal safety net had been extended to the markets (so that no securities firm or clearing corporation would be allowed to fail), and b) the FRB lacked the necessary specialized expertise. Soon after, the authors of the Brady Report said that debate over the proposal bad drawn attention from "more critical issues' and "what is most crucial is not who oversees the [inter-market] issues" but that "we get to work on them." Statement of the Presidential Task Force on Market Mechanisms, 1987-1988 Fed. Sec. L. Rep. (CCH), Par. 84,237, May 1988.

[42] Inter-market Coordination Act of 1988, Hearings before Senate Committee on Banking, Housing, and Urban Affairs, 100th Cong., 2d sess., On *S. 255610-14,77 (1988). The bill* was not enacted. There is at present an Inter-market surveillance Group (initiated by SEC) made Up of stock and stock option exchanges plus the Chicago Mercantile Exchange, that coordinates efforts to eliminate trading abuses.

second and third tasks could be handled with more organizational simplicity either by transferring CFTC jurisdiction of stock-index futures and options on stock-index futures to the SEC, which has already been discussed, or by merging the existing agencies rather than adding a third layer.

Merging Agencies

Merging the SEC and the CFTC has the merits of containing and resolving disputes within one agency, rather than requiring court decisions. This approach also would tend to encourage the use of less parochial criteria in decisionmaking and inter-market coordination. No serious problem of inexpertise should arise, since, the staffs of both agencies would be combined.

The case for consolidation has been stated succinctly by Judge Stanley Sporkin of the U.S. District Court, Washington, D. C., former Director of SEC's Division of Enforcement:[43]

> Our securities markets are too symbiotic to have the kind of separate regulation that now exists between the CFTC and the SEC. . . . An objective analysis of the problem stripped from its political realities would seem to suggest that a single agency should be reposed with the responsibility for overseeing all securities related activities.

Another argument for integration is that having to deal with two hotly competitive industries might help to prevent the regulatory agency from becoming too closely identified with, or captive of, either of these industries.

Many participants in futures industries are convinced that the two regulatory agencies have different perceptions of and attitudes toward the markets they regulate, and that their industry would be disadvantaged if the CFTC is merged with the larger SEC. This perception is reflected in the observation that: "The SEC's world is net long, while the CFTC's world is a zero-sum game."[44] It was said less cryptically by the CFTC chairman Windy Gramm, who told a congressional committee that there is "a conflict of interest" between the SEC goals of stable or higher prices for the benefit of investors, and the duties of a futures regulator, who ''must be insulated from any such price bias in order to maintain price neutrality.' '[45] This implies that the SEC is generally happy to see market prices increase, benefiting the capital formation process and investors; the CFTC is "price neutral,' since in futures markets, for every winner there is a loser.

Some critics of consolidation argue that there is benefit to having competition among regulatory agencies,[46] specially[46] specially, that this stimulates healthy cross-fertilization. To these critics, the many strong disagreements between the SEC and the CFTC are a positive benefit, because they reflect the fact that certainty about many of these issues is not possible. Merging the two agencies, according to this view, "would give the impression of a single view and would stifle responsible discussion of important issues."[47]

But competition between regulatory agencies can also lead to a situation in which the regulated industries tailor their behavior or their products to choose their regulator, thereby setting one agency against another in order to paralyze government response.[48] At present, innovation in products is hampered or completely stymied because the products "fall between the stools" and are likely to involve the exchanges in protracted wrangling between agencies or in lengthy judicial proceedings to determine the proper jurisdiction. If it is the case that the SEC and CFTC have different regulatory philosophies, this may encourage the industry to exploit the bifurcated regulatory regime. In any case, the difference in approach could change at any time with appointment of new Commissioners (or could be influenced by Congress through oversight, budg-

[43]The Honorable Stanley Sporkin, "U.S. Financial and Securities Markets Under Stress, " Address to the Fourth Annual Colloquium on Corporate Law and Social Policy, University of Ohio College of Law, Mar. 6, 1989.

[44]A remark often made by SEC Commissioner Edward Fleischman in speeches during 1988 and 1989. See his speech to tie National Security Traders Association, New York City, July 21, 1988, as reported in *The Market Chronicle,* Sept. *22, 1988,* pp. 8, 10.

[45]Gramm, op. cit., footnote 28.

[46]Edward J. Kane, ''Regulatory Structure in Futures Markets: Jurisdictional Competition Between the SEC, the CFTC, and Other Agencies," *The Journal of Futures Markets,* vol. *4, No. 3, 1984,* pp. 367-384.

[47]Professor Hans Stoll, Director of the Financial Markets Research Center, Owen Graduate School of Management, Vanderbilt University, in correspondence to OTA, July 13, 1990.

[48]See Sirico, "Agencies in Conflict: Overlapping Agencies and the Legitimacy of the Administrative Process, " *VanderbiltL.uwReview,* vol. *33,1980,* p. 101.

etary action, and refusal of conflation of Commissioners). Short-term characterizations of the agencies are not an appropriate basis for making long-term decisions about jurisdictions.

Another objection that has been raised to consolidation is that neither agency has the expertise in or understanding to take over the others' responsibilities. This problem, if it exists, could be handled by transferring or merging staff and by altering the management structure of the consolidated agency. It could be beneficial to disrupt any feelings of identification of regulatory staff with the industries they regulate. Consolidation of two independent agencies would however require careful attention to writing a new organic law. There are sufficient differences in the legislatively mandated structure, scope of responsibility, and authority of the two agencies—as well as in their ethos and cultures as they have evolved during their institutional lifetimes-that merely joining the two agencies, each bringing along its own charter, would probably create a dysfimctional organizational monster.

The most practical barrier to consolidation of jurisdiction is perhaps that different congressional committees now have oversight over the two agencies, and may not be willing or able to agree to consolidation of jurisdiction. One approach could be to create a new single committee in each House with oversight over regulation of the trading of stocks, stock options, and stock futures, or over the trading of all securities (including commodity futures, bonds, etc.). These two committees could then give attentive consideration to the advantages and disadvantages of jurisdictional consolidation, possibly extending to complete consolidation of the two regulatory agencies.