Chairman Markey and Members of the Committee:

Thank you for inviting me to testify today on the subject of intermarket regulation.

The issue is how best to protect the stability and competitiveness of the U.S. capital markets during an era of unprecedented market turbulence. In connection with this discussion, the Commission's Division of Market Regulation has completed a detailed study of trading in the stock, options, and futures markets on October 13, 1989. In less than two hours on that day, the Dow Jones Industrial Average fell 191 points, and investors lost over $160 billion in the market value of their IRAs, mutual funds, pensions, and other investments. Among the key findings of the study, which is being publicly released today, are the following:

1. Index arbitrage significantly accelerated and exacerbated the October 13, 1989 market decline. Indeed, aggregate index arbitrage was higher on a sustained basis than the aggregate index arbitrage levels during the October 1987 market break.

2. Transactions classified as index arbitrage were not
executed simultaneously, but rather through "legging" transactions. Such "legging" transactions contributed to the fall in market prices. These transactions closely resemble speculative trading.

3. Futures selling was focused in small and large speculative accounts, foreign accounts (mostly speculative short-term trading accounts), options market makers and major broker-dealers that were hedging large institutional options put writing. Unlike the October 1987 market break, institutions were net buyers during the relevant period.

4. The stock index futures market did not provide net liquidity to the market. Rather, it was the source of significant net selling pressure on the securities market.

5. At critical times during the price declines on October 13, floor traders on the Chicago Mercantile Exchange were extremely active sellers. Indeed, at the beginning of the market's fall, floor traders on the CME accounted for more than half of all S&P 500 sales, serving as a significant source of market instability.

The issue of how best to regulate our nation's securities and futures markets is not an esoteric question that affects only market professionals. The structure of the regulatory system will have major implications for the future stability and competitiveness of the U.S. markets. Thus, our decisions can have a profound effect on every one of the approximately 50 million Americans who have invested their savings or pensions in the securities market. In New Jersey, Ohio, Massachusetts, California, Pennsylvania -- literally all over America -- the interests of investors, and those seeking employment and economic
growth, are being unnecessarily subjected to greater risk to benefit a tiny minority of professional traders. The Commission shares the concerns of Treasury Secretary Nicholas Brady that the problems caused by the present fragmented regulatory structure are serious in nature, and they are compelling in urgency. The risk to our system, and to millions of Americans, will not go away if we close our eyes to it and fail to take action.

Many of the problems presented by the current regulatory system have been described in depth in our testimony. Therefore, I will touch only briefly on those issues.

First, the present fragmented regulatory system poses a constant threat to the stability of the U.S. capital markets, and indirectly to the cost of raising capital. Because margins on stock index futures are not subject to federal regulation, these margins have often been set at minimal levels that are not sufficient to safeguard the stability of the markets.

Low margin can exacerbate price declines during periods of market stress. During normal market conditions, low margin encourages speculative trading, which creates an illusion of liquidity in the stock index futures markets. When market conditions become extreme, however, these highly leveraged traders withdraw from the market and the mirage of liquidity disappears almost instantly. When
that happens, prices fall rapidly in the futures market. The futures exchanges must then increase margins suddenly and significantly. This is exactly what occurred in October 1987 and October 1989. Sharp increases in margin on October 13, 1989 drained more than $500 million in liquidity out of the S&P 500 market at exactly the worst time.

The futures industry argues that margins are set in order to withstand 95-99% of the possible price moves that may occur, based on the experience of the prior six months. That's like skiing downhill backwards. When it comes to the safety of the market and $3 trillion in public savings, setting margins that will be good enough only 95%, or even 99%, of the time is not adequate. Who will ensure the safety of the system on the 1% of the days when the most dramatic price movements occur?

[The futures industry also argues that the current margin levels are adequate. That is a completely cynical argument. When the market crashed in October of 1987, most margins on stock index futures were around 2-3%. The futures exchanges raised those margins dramatically while changes to the law were being debated in Congress in 1988. Once the debate was over, margin levels were again slashed to 2% -- where they were on October 13, 1989. As a result, the U.S. capital markets have been put at completely unnecessary risk on two separate occasions by leverage on S&P 500 futures contracts of approximately
98%. What will happen this time if the status quo is not changed? There is nothing in current law to prevent stock index futures margins from being slashed again, to the levels of October 1987 and October 1989 or even lower. As President E. Gerald Corrigan of the Federal Reserve Bank of New York recently said:

Partly for this reason, and this is very much a personal view, I believe that margins in many financial-type futures instruments are typically -- if not systematically -- too low. In the case of the S&P 500 futures contract, for example, it seems to me that a significantly higher margin -- perhaps as high as 15 percent or so -- is always called for. I also have serious doubts as to the wisdom of leaving the day-to-day establishment and administration of minimum margins to the exchanges."

A second serious problem is that the division of regulatory authority raises costs, chokes off innovation, and damages the international competitiveness of the U.S. markets. Due to the exclusivity clause of the CEA, U.S. firms seeking to introduce creative new products must first run a gauntlet of expensive and time-consuming litigation.

Index Participations are one example of a specific instrument that has received the death penalty under the exclusivity clause. In more than a half-dozen cases in the past few years, private parties and the CFTC have used the exclusivity clause to challenge the legality of trading specific new instruments in other markets. Even worse, because of the potential for years of delay and millions of dollars in legal fees,
many potential new products will die on the drawing board, and we will never know about them.

The exclusivity provision places U.S. markets at a competitive disadvantage to their international counterparts. Companies around the world can issue hybrid securities in markets outside the United States without having to pay the costs of litigating over whether the instrument in question is 100% a security. Indeed, no valid argument has yet been advanced for retaining the anti-competitive elements of the exclusivity clause for one single day.

A third problem of the current system is that it is extremely costly. As a result of this divided system, which is not followed by any other industrialized country, firms like Merrill Lynch or Shearson that want to advise customers with respect to stocks, options, and stock index futures products must comply with the rules, requirements, and compliance systems of two entirely separate government agencies. Nomura and Daiwa do not have to do that in Tokyo. S.G. Warburg or Deutschebank do not have to do that in Europe. Thus, the U.S. alone incurs substantial unnecessary regulatory costs.

Finally, the fragmented regulatory structure impedes efforts to detect and deter intermarket fraud. Although the SEC and the securities self-regulatory organizations are effective at regulating fraud within the securities and options markets, we only see one half of every
intermarket transaction. As a result, it is almost impossible to know where or when to look for intermarket fraud, or to know which trading is suspicious and should be examined further. Simply put, how can a fire inspector know whether there are too many people in a crowded restaurant if he is allowed to look at only half of the room?

The difficulties in pursuing intermarket trading abuses have been exacerbated by the inability of the securities and futures exchanges to reach prompt agreements concerning information sharing and other intermarket matters. The exchanges have spent years arguing over what activities should be banned. During that time, of course, nothing was banned. Indeed, in the time that it has taken to develop even one narrow intermarket information sharing agreement between the securities and the futures exchanges, the United States and the Soviet Union were able to negotiate and sign several nuclear arms control treaties.

The Administration's bill would transfer stock index futures jurisdiction to the SEC and make stock index futures subject to the anti-fraud provisions under Section 10(b) of the federal securities laws for the first time. At the same time, the SEC would be granted new rulemaking authority to prevent fraudulent, deceptive, or manipulative acts or practices with respect to stock index futures similar to its existing broad authority with respect to stock and stock options. Thus,
the Commission would have the power to provide investor protections such as suitability requirements, insider trading prohibitions, and floor broker dual trading limitations. These are protections for customers that are taken for granted in the securities markets, but they have never before existed in the futures markets.

[The Administration’s bill solves the problems in the markets without imposing significant transition costs on stock index futures market participants. Under the bill, activities in the stock index futures markets will continue to be governed by the CEA. Therefore, new registration or examination requirements will not be imposed, new regulatory issues will not be raised regarding the operation of the stock index futures floors or clearing organizations, and the limited role of the states in the regulation of the stock index futures markets will remain unchanged.]

Under the proposed bill, futures exchanges would not be required to register as securities exchanges or to establish separate subsidiaries to trade stock index futures, unless they chose to do so. In fact, the New York Stock Exchange and other stock exchanges already operate futures exchanges on the same or contiguous floors as their stock exchanges, and they have not suffered from dual regulation by the SEC and the CFTC. Accordingly, the Commission supports the Administration’s proposal as a reasonable and effective approach to the
restructuring of our regulatory system.

In conclusion, the U.S. securities and futures markets are a vital national asset. If we are to protect that asset, however, we must stop the "race to the bottom" with respect to safety and stability. Our current system is a self-inflicted wound on our own cost of capital — an anchor that only American companies have to drag through the water. The fragmentation that has existed for the last eight years should be eliminated before further harm is done to our markets, our own cost of capital, or the confidence of our investors.

A flawed regulatory system has the potential to impose crushing costs on the U.S. economic system. In the wake of the catastrophic cost of the S&L disaster, the American taxpayers are asking why they did not have earlier warning of that potential problem. Of course, there are many differences between the thrift problem and the risks created in this area. Nevertheless, in this case, there is also the potential for severe damage to our overall system. This time we have had not one, but two early warning signals. This time, we should take action before the American public is damaged. For this reason, the Commission believes that Congress should act speedily to adopt the Administration bill.