UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

THE CHAIRMAN

May 4, 1990

The Honorable William M. Diefenderfer
Deputy Director
Executive Office of the President
Office of Management and Budget
Washington, D.C. 20503

Dear Bill:

This responds to the questions you raised during our recent telephone conversation concerning the desirability of a transfer of regulation of stock index futures from the CFTC to the SEC. The current structure of divided regulation of equities and derivatives on equities creates numerous problems. In particular, the current system stifles development of innovative new products, imposes duplicative costs for both the government and the private sector, impedes efforts to detect and prosecute intermarket fraud and creates serious risks to the stability of the overall market in times of extreme selling pressure.

Financial futures serve a valuable economic function. By providing opportunities to hedge risks, they encourage institutions and others to participate in the underlying cash market. Under no circumstances should a transfer of jurisdiction over stock index futures to the SEC, or even a merger of the agencies as some have proposed, be designed to damage the strength and vitality of futures markets. To the contrary, I believe that over time a transfer of jurisdiction would reduce costs, increase credibility, and generally strengthen the futures markets.

Perhaps the most damaging result of the current structure is that it imposes a substantial barrier to new product development. Under the Commodity Exchange Act ("CEA"), the CFTC has "exclusive jurisdiction" to regulate all "contracts of sale for future delivery." In addition, all such contracts must be traded on a CFTC-licensed board of trade. Unfortunately, the CEA does not define a futures contract. Thus, because virtually every securities, banking, and insurance product involves some aspect of a futures transaction, any such product can be deemed to come within the scope of the CEA's so-called exclusivity clause. If the exclusivity clause applies, the product can only be traded on a futures exchange, even if this is not likely to occur, or would sharply narrow the availability of, or interest in, the product.

On several occasions, new products have been developed and have begun trading on securities exchanges under SEC regulation, only to be challenged in court by the Chicago exchanges under the CEA's exclusivity clause. The result has been years of litigation over whether a product falls on one side or the other of the regulatory fence. Last August, the Seventh Circuit considered such a suit challenging new products called "index participations" (IPs) that were trading on the Philadelphia and American Stock Exchanges. The court found that the IPs product contained elements of both a security and a futures. The court's decision held that in such a situation, the exclusivity clause applied, and trading of IPs on those exchanges was declared illegal. The Chicago exchanges that brought suit do not trade IPs even today. Indeed, the only place a product like IPs trade now is Toronto. Sadly, there had been a great deal of investor interest in IPs in this country; more than 74 million had traded during the approximately four months prior to their elimination.

The current regulatory scheme jeopardizes the development of other "hybrid" products that might contain elements of both securities and futures. Under the current system, those products will have to comply with a series of highly restrictive rules adopted recently by the CFTC, or they will have to be traded overseas. Combining jurisdiction over equities and equity derivatives and simultaneously eliminating the monopoly trading privileges created by the CEA's exclusivity clause would greatly enhance the ability of market participants to develop innovative new products free of regulatory disputes and litigation.

A unified regulatory structure for stocks and stock index futures would reduce costs for investors, regulated entities, and the government. The major firms transact business in both the equity and equity derivative markets. This requires their personnel who trade stocks and stock options to be registered with the SEC, while employees who trade futures contracts that may be nearly identical to the options products must be registered with the CFTC. Under unified regulation of stocks, options and stock futures, personnel registration and ultimately other "compliance" requirements could be unified.

This regulatory simplification would increase the range of investment services available to most market participants. For example, under the current system a customer usually cannot be advised by a single broker concerning the relative merits of purchase or sale of stocks or options compared with financial futures. This is because most registered representatives and futures commission merchants are licensed under only one system. A unified regulatory system would make this distinction unnecessary, so that investors should be able to receive advice concerning the full range of equity-based products.

Transferring jurisdiction also would improve systems for detecting and preventing intermarket fraud and other manipulative practices. Tracing and monitoring intermarket transactions is not practical in a fragmented market. The two agencies currently share information concerning trading in their respective markets. However, under the current system each agency only sees one half of intermarket trading strategies. This makes it extremely unlikely that an attempt to engage in intermarket fraud or manipulation can be detected in order even to commence an investigation. It makes much more sense to have a single entity policing both sections of what is, today, a unified market.

It is worth noting that our divided regulatory structure is not followed by any other nation with a developed market. In the United Kingdom, the Securities and Investment Board oversees both stock and futures markets (as well as life insurance). In France, the Commission des Operations de Bourse regulates both securities and futures exchanges. In Japan, the Securities Bureau of the Ministry of Finance oversees trading in stocks, options and futures. Thus, the cost and other problems associated with a divided structure are incurred only in the United States, where it serves to undermine our global competitiveness.

Finally, the current system creates unnecessary risks to the stability of the overall market. Under the current system, margin levels are established by the futures exchanges, which have every incentive to allow unlimited leverage in an attempt to increase trading volume, and hence revenues.

Most stock index futures margins were at approximately 2% when the market plunged steeply in both October 1987 and October 1989. On both occasions margins were raised sharply by the exchanges in the midst of the crisis, draining enormous liquidity out of the system exactly when it was needed most. Indeed, in October 1989 almost $500 million in margin calls were made for stock index futures on Friday and Monday. Federal Reserve Chairman Alan Greenspan testified recently that he had been "shaken" by the risks created by these sharp margin calls. Unfortunately, without some form of government controls there is not any reason to believe that an adequate margin of safety will be maintained in the future. The result is a risk that a sharp drop in the market could be turned into an uncontrollable collapse.

While the likelihood of such an economic disaster might be remote, there is in my view an overwhelming interest in avoiding any unnecessary risk of a problem of such awesome potential magnitude. Indeed, leaving the formal responsibility for protecting the public to a private group seems indefensible in light of what we should have learned from the cost of the thrift debacle. To reiterate, however, the objective here should be to take practical and workable steps to reinforce the stability of the market.*

I am glad you happened to ask about this issue. I sincerely believe this situation offers a genuine opportunity to improve the effectiveness of the regulatory system from the perspective of both maintaining stability and preventing fraud. At the same time, it would reduce costs and barriers to competition in the private sector both here and abroad. The proposed change would strengthen both securities and futures markets, through significant improvements to efficiency and international competitiveness.

Sincerely,

Richard

Richard C. Breeden
Chairman

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* For a significant period following the 1987 crash, stock index futures margins were maintained at sharply higher levels, without apparent damage to this market.