Testimony of James R. Jones
Chairman, American Stock Exchange, Inc.
Before the Senate Committee on Banking,
Housing and Urban Affairs

July 11, 1990

My name is James R. Jones. I am Chairman of the American Stock Exchange.

I commend Senator Dodd, Senator Heinz and the Committee for conducting hearings on the question of federal jurisdiction over the securities and stock index futures markets as well as the Administration's legislative proposal - the Capital Markets Competition, Stability, and Fairness Act of 1990. The questions raised by the current jurisdictional debate are among the most pressing in the securities and futures industry today and this hearing hopefully will shed light on the needs that the Administration's bill addresses.

I also wish to express support for the initiatives of the Ad Hoc Coalition for Intermarket Coordination in which the American Stock Exchange is a participant, along with other securities self-regulatory organizations. The Exchange shares the jurisdictional concerns expressed today by Wayne Luthringshausen in his testimony on behalf of the Ad Hoc Coalition.

The increasingly heated debate over SEC/CFTC jurisdiction has brought into focus two principal concerns that warrant Congressional action. First, while no one appears to contest that the stock, options, and stock index futures markets comprise "one market", as the Brady Task Force concluded following the October 1987 crash, serious regulatory bifurcation and inconsistencies exist.

Second, our securities marketplaces have been seriously disadvantaged as a result of the expansive interpretation given by the U.S. Court of Appeals for the Seventh Circuit to the "exclusivity clause" of the Commodity Exchange Act in its 1989 decision relating to Index Participations. Because the Supreme Court recently has declined review, the Seventh Circuit's decision is now the law of the land. Under that decision there is a danger that any product with an element of futurity, and not just stock index futures, may well be subject to exclusive CFTC jurisdiction. At the very least, there will be uncertainty and a proliferation of litigation to test the outer bounds of the "exclusivity clause." As a result, the initiatives of our securities marketplaces to develop new retail and institutional products, and to trade and market them as securities, will continue to be stifled.

The Administration's proposal to address these issues recognizes what common sense dictates - that integrally linked

market segments must be subject to regulation that is unified and consistent. The Administration's bill is comprehensive but, at the same time, avoids unnecessarily intrusive new regulation. By providing for SEC oversight over stock index futures, as well as amending the CEA's "exclusivity clause" to undo the effects of the Seventh Circuit's decision, the Administration's proposal will enhance the soundness of our linked equity and derivative markets. At the same time, the proposal would eliminate competitive barriers to development of innovative and useful securities products and, indeed, would encourage their development. I, therefore, strongly endorse the Administration's initiatives, which I believe are critical to maintaining the integrity and international competitiveness of our markets.

Stock Index Futures Jurisdiction

Unified regulation across linked markets is a necessary adjunct to reduced market risk for all market participants and to increased investor confidence. While the securities and futures markets each have taken a number of steps, both individually and in concert, to remedy the most serious systemic weaknesses that became all too apparent after the October 1987 crash, regulatory disparities between stock and stock index futures markets continue to thwart comprehensive

measures to further reduce market risk. The Brady Task Force Report identified margin, coordinated clearance and settlement procedures, circuit breakers, and surveillance as areas that require unified responses. Moreover, a single regulator of linked markets is necessary to address future market crises and to implement preemptive measures to deal with market volatility. By providing consolidated regulation, the Administration's bill promotes the soundness of our markets as a whole.

Disparate margin requirements for stock index futures and equities also require unified regulation, specifically SEC oversight, as the Administration has proposed. Futures exchanges currently can increase speculative and hedge margin requirements abruptly during rapidly declining market conditions, which may contribute to market risk by impacting market liquidity and affecting payment systems. Likewise, margin requirements could be reduced, when markets are relatively stable, to levels far lower than those required for securities. Different margin levels may be appropriate in view of the different functions of futures and equity or options margin, but margin levels must be set to minimize risk to the market as a whole and permit better evaluation of credit risk. Margin levels must be coordinated because our markets are interactive; margins established in the futures, options, and

equity markets inevitably impact each other. The setting of margin levels is much too important to the health of our financial markets to continue to be subject to the competitive instincts of individual futures exchanges. Therefore, coordinated margin regulation under the oversight of a single regulator, as the Administration's bill provides, will serve to reduce the level of risk resulting from precipitous increases or decreases in required margin levels under varying market conditions.

Adequate systems for cross-margining, which can provide critical market efficiencies, also would be facilitated by unified regulation. It is essential that clearing corporations and exchanges be able to accurately assess risk in relation to the overall exposure of clearing members in related markets. A cross-margining system under the oversight of one regulator will improve risk assessment and permit more efficient deployment of funds to meet changing market conditions. Similarly, to facilitate the timely assessment of the financial condition of member firms, a single regulator would promote the integration of securities clearing agencies and futures exchange clearance systems.

From a broader perspective, we also must keep in mind that we may not yet have experienced all possible challenges to

the stability of our markets. The amazingly rapid development of international securities and futures markets and of new domestic and global trading mechanisms may impose new market risks that may be even more difficult to grapple with than those which our markets have already encountered. Securities and futures exchanges here and abroad are working towards innovative technologies for trading and disseminating market information, on a 24 hour basis. We cannot know fully what new risks these new systems will introduce. Again, providing a single regulator over linked market technologies, comparable to the unified regulatory scheme for securities and futures that exists in all other countries, is the most efficient and responsible course of action. The Administration's bill facilitates this important goal and, I believe, will improve the worldwide competitiveness of all of our domestic markets - securities and futures.

Moreover, unified regulation will not impede competitiveness and innovation in our markets. Some have suggested that a jurisdictional split fosters intermarket competition and that the CFTC has done more to foster innovation than has the SEC. This is not the case. The securities industry today is fiercely competitive, and competition in the development of new securities products and technology has been furthered by SEC initiatives and

oversight, which has been responsive and pro-competitive. Competition between futures and securities markets will be no less intense if the SEC oversees stock index futures.

CEA "Exclusivity Clause"

The Administration's proposal also addresses the barriers to competition and innovation created by the CEA's "exclusivity clause." The Seventh Circuit has nullified the SEC's approval of an important new product - Index Participations - based on the court's expansive interpretation of the "exclusivity clause". Without new legislation, securities exchanges arguably will have to demonstrate that a product designed for trading in a securities marketplace, and intended for traditional retail and institutional securities investors, is not a futures contract, and, indeed, lacks any element of futurity. I believe this is an unreasonably onerous requirement, particularly since the Seventh Circuit has taken an extremely broad view of what constitutes futurity in regard to financial instruments. Indeed, a number of traditional securities could be argued to have some element of futurity under this court's rationale, and thus the decision may cast a cloud over which agency has jurisdiction in areas previously thought to be clearly within the domain of the SEC.

I applaud the Administration's initiative to undo the effects of the court's decision by permitting instruments such

as Index Participations to be traded on securities exchanges under the SEC's oversight.

The principal effects of the Seventh Circuit's decision are two-fold. First, it is less likely that securities markets will pursue development of securities products that may not survive analysis under the Seventh Circuit's decision. The considerable resources that the American Stock Exchange and other exchanges have applied to developing, marketing, and commencing trading in Index Participations, and in subsequent litigation, has resulted in a new judicial gloss on the CEA, albeit that a useful new investment vehicle has been denied to U.S. investors. But foreign markets, unencumbered by bifurcated securities and futures regulation, are encouraged to develop and trade abroad instruments such as Index Participations or similar products. Thus, at a time of burgeoning global markets, domestic securities markets are saddled with a legal framework that operates to our competitive disadvantage.

Second, in being denied Index Participations, our markets have lost the benefits of a possible means of tempering market volatility by alleviating market pressure generated by program trading and index arbitrage. The SEC, in fact, determined that Index Participations have this potential. Indeed, Index Participations were developed following calls by

the SEC and others, after the 1987 crash, for market basket-type products that could deflect the market impact of program trading and index arbitrage.

In addition, individual investors have been denied the opportunity to purchase stock index-based instruments with intra-day market liquidity and thereby to participate in market trends as institutions do.

I would emphasize that Index Participations were designed as securities for both retail and institutional securities customers, and it is impractical to suggest, as some have, that such products could be readily adapted to the regimen applicable to futures customers. In the eyes of the public, futures are associated with speculation and hedging, not long term investing. The futures market has a far more limited retail customer base than its securities counterpart. Securities and commodities account approvals are not fungible, nor is registration for futures commission merchants and securities account executives. Many institutions are precluded from trading commodity futures. Margin requirements and clearance/settlement procedures, of course, are different for securities and commodities; and whereas IPs were margined as equities, and were designed primarily as alternative investment vehicles, stock index futures serve mainly speculation and hedging functions. IPs were designed for the securities

marketplace; the many different features of the commodities market and its customer base were not compatible, in our view, with a successful Index Participations product.

The securities markets require legal and jurisdictional certainty; anything less will deter new product development and innovation. If our markets are to maintain and improve their competitiveness, domestically and internationally, exchange initiatives to create new instruments should be permitted to succeed or fail based on their merits and their usefulness to market participants. By enacting the Administration's proposal amending the "exclusivity clause", Congress will remove a serious competitive impediment and foster development of constructive new products.

I would stress that it is important that the statutory framework make absolutely clear that a product approved for trading on a securities exchange or in the securities markets would indeed be a security, and not a futures contract, for all purposes under the law. This is essential if we are to avoid inviting further regulatory confusion and possible litigation under the securities laws, the CEA, the Internal Revenue Code, or any other statute in which securities or futures are referenced.

In closing, I would acknowledge, as we all know, that there is serious disagreement about the impact of stock index

futures trading or of disparities between futures and securities margin on market volatility. Most recently, the CFTC and SEC have come to widely differing conclusions on the market effects of program trading in their studies of the October 1989 market break. These disagreements are rooted in the multiplicity of complex facts and trading patterns that must be analyzed before any plausible conclusions can be drawn. Whatever the cause, however, the problem remains a real one for investors, for member firms, and for market makers, each of whom bears unique risks as a result of volatile markets - particularly rapidly declining ones.

It does not help solve the problem to say that a link between stock index futures trading and volatility has not been proven. Our markets do not have the luxury of time to wait for "proof", if it ever comes. We need to put in place new mechanisms to enhance investor confidence and to assure that we can withstand and survive extreme and increasingly unpredictable market pressures. I believe the Administration's proposal, by consolidating regulation of our equities and derivative markets, aims to place all market segments in a much stronger position to withstand such pressures - now and in the future.

I appreciate this opportunity to share my views with the Committee.