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News Release

INTERNATIONAL OPTIONS

Remarks to

The Third General Meeting of the
International Association of
Options Exchanges and Clearing Houses

The Philadelphia Stock Exchange
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Good morning. I appreciate the opportunity to attend this Third General Meeting of the International Association of Options Exchanges and Clearing Houses. The Securities and Exchange Commission participates in a number of international groups, and I know that a meeting like this can go a long way toward fostering cooperation, communication, and ultimately, coordination. I look forward to discussing development of the international options and futures markets with you and my colleagues, Commissioner West, Ms. Corcoran and Mr. Ketchum. As a brief introduction, I would like to review a few of the major products and trading techniques new since your last meeting in 1985, and the implications these have for our jobs as regulators of the options and futures markets. I have captioned my remarks "International Options," referring not only to the securities themselves but also to the many alternatives available to market participants. We must keep open as many options as possible, and let the market sort out the desirable from the undesirable. Although regulatory intervention may at times be required, I believe it is important to ensure that competitive pressures remain the primary architect of these markets.

New Product and New Trading Development

In reviewing the major developments since 1985, I'd like to start with a little bit of your history. Mr. Giordano was kind enough to provide me with a copy of the minutes of your 1985 meeting in Sydney. I found especially interesting the section titled "A Look into the Future."[1] After hearing reports from each participant, the group identified five areas of particular interest:

- development of international links;
- the impact of non-exchange trading networks in comparison to similar issues involving stock trading;
- intensified competition, which could be expected to reduce the number of exchanges;
- wide dissemination of market information; and
- cooperation between clearing houses.

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1 International Association of Options Exchanges and Clearing Houses, Minutes of 2nd General Meeting Held in Sydney, Australia on 9 and 10 April, 1985, at 11-15.

I think this captures, in a nutshell, all the major concerns in development of international options and futures markets. The effects of competition on market structure and the development of non-exchange trading networks are, I think, the most important on this list.

Since that time two years ago, innovations in the market have taken place much along these lines, which I believe shows the remarkable prescience of this group. On the other hand, perhaps I shouldn't be so surprised, because successful predictions are virtually a prerequisite for success in your business. As an economist, I am not usually subject to this type of pressure. If an economist's prediction turns out to be incorrect, he can usually blame it on the world for failing to behave in a way consistent with his models and assumptions, which are surely correct.

First, let's review some of the new products. Stock index futures have come to the international market. The Toronto Stock Exchange has designed a comprehensive program for trading stocks, options and futures on the new TSE 35 Index.[2] In addition, so-called "synthetic futures" are being developed by upstairs firms, in order to provide hedging capability in markets where stock indexes are not available.[3] I think it's important to note that each product was created in response to intense demand, particularly from institutional traders. It will be interesting to watch these products develop in Japan. Japanese institutions were only recently allowed to trade for their own accounts on futures exchanges outside Japan.[4] Because of legal restrictions, the Osaka Stock Exchange's proposed future on an index of 50 actively traded stocks settles by delivery of the securities; but the OSE intends to replace this index with a cash-settled one as soon as the law permits, and is considering the Nikkei stock index, currently traded in Singapore.[5] This group noted in 1985 that cash-settled contracts are urgently needed in

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2 Toronto Exchange Installing Advanced Program Trading System, Investment Dealers' Digest, June 8, 1987, at 54.

3 Firms Designing Futures on Foreign Stock Indexes, Investment Dealers' Digest, June 1, 1987, at 6-7.

4 Abbott, 'Round the Clock no Longer Limited to 'Round the World, Futures, June 1987, at 44.

5 Fulscher, A New Market in Japan, Financial World, June 30, 1987, at 42-43.

international futures trading; indeed, this remains a significant issue two years later.

Stock index futures are probably the most important new product in the international market. Experience in the U.S. has shown that they make hedging more efficient and less expensive. Traders are driving development of these new products. An article in The Economist recently noted that "traders in European markets are beginning to want the choice of stock market gadgetry available in American markets."[6] Although I think the term "gadgetry" is a little pejorative, I think this expresses the right idea.

Next, let's look at new trading methods. Two new linkages have been developed: the American Stock Exchange and the European Options Exchange announced plans to trade options on the Amex's Major Market Index on the EOE,[7] and the Commodity Exchange and the Sydney Futures Exchange linked and began trading at the end of last year.[8] Domestic options and futures exchanges are lengthening their hours, in an effort to compete with markets which have forged trading links. The Chicago Board of Trade began evening sessions two months ago, and is now considering expanding them to include Sunday evening, in response to demand for hours coinciding with the Japanese markets.[9] The extended hours bring the Board of Trade's Treasury Bond futures contract into competition with similar contracts traded in Singapore and Sydney, although trading there may not be accommodating institutions very well.[10] And just last week, the London International Financial Futures Exchange announced that its T-Bond

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6 London's Bubbling Market in International Shares, The Economist, May 30, 1987, at 74.

7 Amex Says Options Will Trade in Amsterdam, Wall St. J., Feb. 20, 1986, at 5, col. 3.

8 CFTC Approves Rules Implementing Trading Link Between Comex and SFE, 18 Sec. Reg. & L. Rep. (BNA) 1221 (Aug. 15, 1986). Trading through the linkage began on November 20, 1986.

9 Abbott, supra note 4, at 45. The Philadelphia Stock Exchange has proposed evening sessions also. Id.; see also Philadelphia Exchange Plans Nighttime Options Trading, Am. Banker, Apr. 2, 1987, at 25.

10 "[V]olume [in Singapore and Sydney] has not reached a level that commercials can use easily." Abbott, supra note 4, at 45.

futures contract will be made identical to the Board of Trade's contract in pricing, allocation, and delivery.[11] Worldwide competition and accommodations are developing quickly.

The nature of the traders is changing as well as their trading methods. Highly-capitalized Japanese brokerages, banks, insurance companies, and money management firms now trade for their own accounts on United States exchanges.[12] Overall, the market is becoming predominantly institutional. These institutions are looking overseas for investments, although the U.S. lags behind the U.K. and Japan in this area.[13] More importantly, these institutions realize that improved riskless returns are available through portfolio trading, and are demanding dynamic hedging products such as index options and futures. The trading system developed by the Toronto Stock Exchange, for example, is directed at just such traders.[14]

Regulatory Responses

Having looked at the major new products and new trading methods, I'd like to briefly discuss whether and how to respond to them with regulation. As you're no doubt aware, I'm a firm believer in competition in most areas, and provision of securities trading services is no exception. I'm intrigued by the extent of competition developing in the international markets. I expect the regulatory role to be limited where competitive efforts are being made. I will use two problem areas as examples: clearing of transactions, and market surveillance and oversight.

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11 See "LIFFE U.S. T-Bond Futures: First Step to Fungibility," Wall St. J., June 29, 1987, p. 31, col. 4 (advertisement).

12 See The Japanese are Elbowing into Chicago's Futures Pits, Business Week, June 1, 1987, p. 106.

13 In 1986, pension fund assets invested overseas as a percentage of all assets was an estimated 16 percent for U.K. funds, 10 percent for Japanese pension funds, but just under 2 percent for U.S. funds. London's Bubbling Market in International Shares, supra note 6, at 74.

14 Toronto Exchange Installing Advanced Program Trading System, supra note 2, at 54.

As with any securities trading operation, clearing of options and futures trades is a routine but vital process. One solution to difficult clearing problems is the "mutual offset system" used in the Chicago Mercantile Exchange link with the Singapore International Monetary Exchange.[15] A different method was used in the recent linkages between Amex and the EOE and between Comex and Sydney, where trades clear through one agency without the mutual offset process.[16] The Options Clearing Corporation had developed, in connection with the proposed but now abandoned Philadelphia-London linkage, an "international market agreement," for use by any linked exchanges.[17] This omnibus-type agreement was similar to that adopted in the Amex-EOE linkage.

To be effective, clearing agreements must strike an appropriate balance between competing considerations. On one hand, it is important that the development of clearing arrangements be supervised. Participants in this meeting two years ago stressed that proliferation of different clearing systems can only lead to difficulties. When the Securities and Exchange Commission sought comment on issues concerning global securities trading, the letters indicated that no regulatory action was necessary now, but the SEC should make sure that clearing and settlement develops efficiently.[18] On the other hand, clearing arrangements should not be unilaterally imposed. Most commentators who addressed the clearing issue in the SEC's request for comments believed that clearing arrangements should be in a form different from either described above. They advocated "reciprocal clearing membership" by each clearing agency in the other. These would be more direct than mutual offset

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15 See Chicago Mercantile Exchange; Proposed Rule Amendments, 49 Fed. Reg. 16,827 (1984).

16 Trading through the Amex-EOE link will clear through the Options Clearing Corporation; see American Stock Exchange, Press Release at 2 (Feb. 19, 1986). Trading through the Comex-Sydney link will clear through the Comex Clearing Association; see Commodity Exchange, Inc., Proposed Rule Amendments Relating to a Linkage Agreement With the Sydney Futures Exchange, Ltd., 51 Fed. Reg. 12,539 (1986).

17 See Securities Exchange Act Release No. 22354, 50 Fed. Reg. 35,340 (1985), amended by Securities Exchange Act Release No. 22847, 51 Fed. Reg. 4551 (1986).

18 See Global Trading Release - Summary of Comments 16 (File No. S7-16-85, Jan. 16, 1986).

systems, but would not subject one clearing agency to another's requirements without corresponding obligations by the other, as would the OCC's proposed "international market agreement." The International Commodities Clearing House wrote, for example, that "it [is] a basic prerequisite of any international linkage ... that each clearing house maintain its historical relationship with its native exchange and that the clearance of 'international' trades be divided between the two clearing houses, not by one assuming clearing responsibilities for both."[19]

In the area of market surveillance and oversight, the new products and trading techniques suggest a host of problems that will need to be addressed. The emergence of stock index futures on the global market may raise questions about unwinding and expiration effects which the SEC and the CFTC have been trying to answer in the U.S. market. Efficient hedging requires that derivative products expire near in time to each other, but I believe that with effective product design, global witching hours or days need only be a theoretical possibility. Questions about non-expiration effects may not be as easily answered.

The development of upstairs trading and synthetic products by securities firms poses new issues in the structure of the industry. Until now, what has separated options and futures trading from stock trading is the absence of an "upstairs" market. In a recent study of development of international stock exchange linkages, I concluded that it is in part this difference which explains why stock markets are forming contemporaneous links, but commodities markets are forming sequential links or lengthening their hours. Stock markets have chosen not to compete with the upstairs 24-hour market, but commodities markets have had no such competition until recently. Chicago Board of Trade Chairman Bob Goldberg observed that "[t]he competition of off-exchange [products] is more important now than the international expansion. We're competing against upstairs trading that can service a customer 24 hours a day."[20] This competition with upstairs firms is one which the stock markets have declined. Therefore, it may raise new issues in surveillance and oversight as organized markets seek to keep pace with, and outperform, the in-house passing of the book. In addition, contemporaneous links may also be developing in the options

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19 International Commodities Clearing House Ltd., Letter of Comment 8 (File No. S7-16-85, Dec. 10, 1985).

20 Abbott, <u>supra</u> note 4, at 45.

and futures markets as in the stock markets. The Chicago Board of Trade and the Chicago Board Options Exchange recently announced an agreement to jointly develop financial futures and options and to allow side-by-side trading.[21] The Toronto Stock Exchange has formed a similar "linked" operation internally.[22]

The Importance of Competition

I believe this brief survey shows that development of new products and new trading methods raises new issues in market structure that should be considered by regulators. There is a tension between the need to see that new markets develop properly, and the need to avoid stifling competition with regulation, however well-meaning. One recent example is the SEC's decision a few weeks ago to reverse its position of seven years and allow multiple trading of options on exchange-listed securities.[23] Although we still were not assured that the markets have developed sufficient protections against illiquidity and volatility, we concluded that these may never be developed if competitive trading is perpetually postponed. I believe that this must be the right answer. If we, as regulators, can ensure that market surveillance is effective and complete, competition should be allowed to determine market structure. In the area of clearing arrangements, if safety and speed can be assured, and reliable records can be produced when required, we should not specify which of the methods -- mutual offset, reciprocal clearing membership, or subsidiary membership -- ought to be used. In the area of trading arrangements, marketplaces are competing with each other in two different ways: first, through sequential linkage and longer hours, and second, through contemporaneous linkages to provide side-by-side trading in options and futures. Each of these may involve different types of competitive motivations, and have different benefits and costs. The participants are in the best position to judge the merits of each of these alternatives. The regulators are in the best position to judge whether the chosen alternative promotes effective market surveillance and oversight and protects investors. If each group sees that its goals are met, we can keep all of our international options open.

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21 Exchanges Announce Trade Link, Chicago Tribune, June 26, 1987, at 1.

22 See discussion of the TSE's proposal at p. 2.

23 See Securities Exchange Act Release No. 24613 (June 18, 1987).