NEWS
SECURITIES AND EXCHANGE COMMISSION
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REMARKS TO
OPTIONS SEMINAR
SECURITIES INDUSTRY ASSOCIATION
NEW YORK, NEW YORK
JUNE 3, 1980

# "REVOLUTIONARY CHANGE IN THE FINANCIAL MARKETS"

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The decade of the 1970's saw revolutionary changes throughout the financial markets. I would like to discuss with you some observations about the way government reacts to changes of this kind. They cast some light on the experience of your industry with the SEC's option moratorium and what we can expect for other financial instruments:

<u>First</u>: in general, the law will tend to adopt structural changes in the markets but only in the absence of serious abuses.

<u>Second</u>: recent changes in investment products, generated by the inflationary excesses of the 1970's, posed an unprecedented challenge to our traditional regulatory structure.

<u>Third</u>: the development of new speculative products relating to fixed income securities has generated a concern about the need to protect less sophisticated financial institutions.

<u>The Law Follows the Markets</u>

The early 1930's saw adoption of a plethora of legislation affecting financial intermediaries: banks, savings institutions, securities firms and, somewhat later, investment companies. Just as in Ecclesiastes, everything was well ordered. One could tell a savings and loan from a bank by looking at its business. After adoption of the Glass-Steagall Act, it was generally well accepted that securities firms did some things and banks did other things. Each neat little category had a specially tailored regulatory system with a separate alphabet-agency regulator to administer the rules.

That system stayed in place through the mid-1960's. Then, in 1966, 1969 and again and again in the 1970's, we experienced increasingly severe bouts of inflation. That inflation was a rich fertilizer for change in the financial markets:

- in the banking and savings industry, new channels appeared to funnel savings around the inhibiting effects of Regulation Q's deposit interest rate controls: money market funds, bond funds, six-month certificates, large bank CD's, and in the end, a bank consumer instrument with the wonderfully candid name of "loophole certificates."
- in the securities industry, inflation has weakened equity markets, and individual investors have fled in droves. About 70% of the trading on the New York Stock Exchange now represents institutional investors, up greatly from the 60's. At the same time, the individual investor's desire for speculative gains has not diminished. Indeed, I would venture to say that the strains of inflation and the devaluation of financial assets have increased both the number of speculators

and their desire for large gains. This pressure has become focused on futures and options, which offer great leverage.

- in a related development, the failure of savings institutions to cope with the need for mortgage credit has led to a series of government credit programs -- exemplified by Ginnie Mae -- that have transformed the face of the mortgage credit markets and created a new need for investors who will assume the risks of interest rate changes.
- the difficulty of managing an inventory (or a portfolio) of fixed income securities in such volatile interest rate cycles has led to increasing use of interest rate futures.

It is remarkable that all of these developments have proceeded in the face of a regulatory system that was designed for a very different world. The fact is, that in the absence of significant abuses, the regulatory system tends to permit what the markets develop. That fact is extraordinary in view of the serious public policy questions that are raised by many of these developments. For example,

- what are the implications of the money market funds for many of the basic concepts in our banking system?
- is it wise to create a system in which individual investors must shoulder a major portion of the speculative risk inherent in interest rate movements?
- what are the implications of these developments for the underlying securities markets to which they relate?

Of course, there is nothing new in speculation. But the justification for lending the sanction of organized exchanges and governmental protection and oversight to speculation must be sought in other values. In the case of the equity and bond markets, these values are found in the importance of active, broad and liquid secondary markets to the raising of capital. In the options and futures markets, the primary value lies in the process of transference of risk. But CFTC Chairman James Stone has noted that the futures markets in Treasury securities are dominated by speculators.

In any event, when goverment reviews these questions the answer has often proved to be a Scotch verdict of "not proven," accompanied by a sense of unease. Regulators, properly reluctant to stand in the way of developments that seem responsive to deep running economic forces, go forward anyway, turning to what they know best -- insuring that growth is orderly, that the markets are stable and fair, and that investors are protected. That is certainly a fair description of the growth of the options markets, which no longer have the status of a "pilot project."

The sense of unease remains however. And where there are major abuses, when there is a strongly perceived danger to our financial system, then the regulators and the Congress will act, and act quickly. Crises of that kind give rise to the McFadden Act, which prohibit interstate branching by banks, and the Glass-Steagall Act, which eliminated banks from many aspects of the securities industry. The army of Congressional committees and regulators investigating the imbroglio in the silver market in and around April Fool's day this year demonstrates that this process is still at work. Similarly, legislation is now pending in the Congress to regulate the Ginnie Mae forward market. It grew out of a series of trading abuses and marketing excesses.

For these reasons, it is the securities industry, and each of you, that have the greatest interest in an effective regulatory system that insures the integrity, efficiency and stability of the markets and protection of individual investors.

The lessons of history are very clear, especially for markets like options and futures, which are essentially derivative.

Current Challenges to the Regulators

The genius of our financial system lies in its ability to respond to economic events in new and innovative ways -- to use the best of what we have learned to cope with new problems. That has certainly been true of the options exchanges, which have built on experience with the equity and bond markets to bring higher levels of competition and technology to market making and surveillance. The growth of the options markets has been enormously impressive.

At the same time, we have seen an explosive growth in the futures markets and, of special interest to the SEC, in financial futures and forwards. If one looks at the nature of the financial instruments, the persons marketing them and the exchange markets, until recently it was fair to conclude that commodity futures contracts and options on securities -- not to mention investment securities -- were quite different animals. And one could be comfortable with different regulatory patterns.

Two developments have strained that approach. First, from the point of view of the investor these sophisticated financial instruments are becoming highly substitutable investment alternatives. Once individual customers have assumed the speculator's role regarding interest rate movements, then futures contracts on Treasury securities and Ginnie Maes, options relating to fixed income securities and Ginnie Mae forwards are just different varients of the same game. One can question the efficiency of permitting the public markets to offer so many varients; more important, however, is whether it makes sense to have different rules apply to economically similar transactions.

Second, the instruments, the salesman and the firms involved are moving closer together. Various future exchanges have pending proposals for futures contracts representing different broadly based equity market indices and, in one case, smaller baskets containing securities representative of particular industries. In turn, the CBOE has proposed a program of options on Treasury securities and Ginnie Mae pass-through securities. At the same time, an increasing volume of interest rate futures business is being done through securities brokers and dealers, and the stock exchanges have begun futures exchanges.

There were -- and are -- many differences in regulatory treatment between the securities firms and commodities futures merchants: the margin rules, net capital rules, suitability standards, the quality and degree of disclosure, treatment of pooled investments, and the like. The two commissions are working together to identify the more important differences. Some progress has been made, but significant differences remain, particularly in the margin area.

Moreover, even if the major differences could be erased by cooperation, we have to ask ourselves whether it makes sense to have different regulation of similar financial instruments by different agencies. These are analogies; the most obvious is the proliferation of federal and state regulators making up what has been called the duál banking system. As in the case of options and futures and Ginnie Mae forwards, the regulatory arrangements are largely an accident of history. But the debate today is not about history. For historical accidents have a way of creating their own justifications. The debate concerns the advantages of dispersion of power and introducing competition in regulation to lighten its sometimes deadening hand versus the excess costs and real impediments to the implementation of government policy on the other.

For my own part, whatever one thinks about the dual banking system in retrospect, I am not prepared to create a new one in prospect. I think that we should be reducing the number of agencies regulating each sector of the economy, not increasing them, and reducing competitive inequalities that grow out of history rather than function.

The growing together of the markets for futures contracts relating to securities and other instruments provides, in my view, a compelling reason to revisit the question of divided jurisdiction. The SEC has supported legislation that would vest in it jurisdiction over futures contracts relating to non-exempt securities. I think that is the correct result. The question of futures relating to exempt securities is more complex because of other interests, such as those of the Treasury in management of the public debt. Nevertheless, the characteristics of speculative instruments relating to Treasury securities are so different from the characteristics of the underlying securities -- as is the case with investment companies that invest in these instruments -- that this question requires careful attention.

Financial Institutions

Finally, the development of new varients of fixed income securities has raised a whole set of new questions about the relationship between the broker-dealer (and FCM) community and financial institutions. There was a time, not too long ago, when bonds and money-market instruments were the exclusive province of the most conservative end of the investment rainbow. But the sharp interest-rate cycles of the 70's and the recurrence of an inverted yield curve have made losses as easily available in high-quality fixed income securities as in equities. And depository financial institutions have exhibited a desire to both hedge and speculate. That is quite a new development and it raises thorny problems.

It is conventional wisdom in the SEC's regulation of the issue of equity securities that institutions can fend for themselves. That notion underlies almost 50 years of lore in the private placement area as well as numerous rules specifying exemptions from the securities laws. In general, the "institutions" with which those rules are concerned are not traditional depository insitutions such as banks and savings and loans -- except perhaps in the area of trust operations. However, if there is one area in which one would think an organization in the business of buying money (through deposits and otherwise) and making loans should not need the protection of the SEC, it is in making judgments about interest rate movements.

In addition, the range of permissable assets and liabilities of such institutions are closely supervised by their regulators: the Federal Reserve, the Comptroller of the Currency, the FDIC, the Federal Home Loan Bank Board and the National Credit Union Administration, not to mention the corresponding regulators of the 50 states. Many of these agencies have adopted or proposed rules limiting the ability of institutions to engage in Ginnie Mae forwards and stand by arrangements.

At the same time, we have in this country almost 15,000 commercial banks, 5,000 savings institutions and over 20,000 credit unions. Is it realistic to ascribe sophistication to all of these? If not, does it make good regulatory sense to avoid problems by intercepting inappropriate conduct by broker-dealers and FCM's? In my view, we cannot just carry over broker-dealer obligations designed for the special relationship between a broker and his customer and apply them wholesale to this quite different relationship. At the same time, we cannot be blind to the fact that Commission investigations have uncovered a substantial amount of overreaching and inappropriate conduct in, for example, the marketing of Ginnie Mae forward positions. This area contains many thorny problems, and we need your help in arriving at a sensible resolution of competing interests.

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Finally, it is worth saying that the exercise of accomodating regulation to drastic changes in the markets will never move us back to the days of financial institutions divided into neat little catagories which are replicated by the regulators. The markets will continue to change -- you will continue to invent new products -- and we will continue to try to achieve the goals that the Congress has set for us without distorting economic behavior.

The increasing substitutability of different investments and the interrelationship of different markets -- witness the widespread effects of recent events in the silver markets -- means that we must take an even broader view. The Commission's pole star has long been regulation that is consistent in its purposes and coordinated in its application. Recent developments will pose even greater challenges to our understanding of the markets and the role of speculative activity.