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A CITIZEN'S CONCERNS IN THE DEBATE OVER HYBRID INSTRUMENTS

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My thanks for the opportunity to speak at this meeting are owed to Mahlon Frankhauser, chairman of the Committee on Futures Regulation, and to Sam Scott Miller, chairman of the Subcommittee on Market Regulation of the Federal Regulation of Securities Committee. My credentials to justify your attention here are my longtime membership in both groups and my onetime practice in both fields.

I requested the opportunity to speak this morning because, like last summer, I am very concerned about certain fundamental issues in the ongoing debate over regulation of hybrid instruments. The issues that I think demand attention are not securities market or SEC-oriented issues and are not futures market or CFTC-directed issues; rather, they are issues of federal market-regulatory structure.

Because they <u>are</u> issues of structure, basic to decisions on allocation of regulatory authority without reference to the current debate, and because they involve the very ability of hybrid instruments to achieve entry into the American financial markets, these issues should be doubly meaningful to this audience. First of all, you are citizens of these United States personally affected by allocation of federal regulatory authority, and, second, you are lawyers responding to the impact on your clients (who are citizens, too) of federal regulatory policies that facilitate, or that bar, the utilization of hybrid instruments for capital-raising and other legitimate economic purposes.

In all this, of course, I speak for myself. My views, as you know, are not the views of the Securities and Exchange Commission, of any of my colleagues on the Commission, or of the Commission's staff. I speak solely as one citizen, and lawyer, to others. In contrast to last year, however, I speak in concord with the publicized position of the SEC.

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As I did last summer, so now I invite you to step away from the interagency

argument and to assess the regulation of hybrids from the point of view of public expectation: what we all, as citizens, expect from the market regulatory policies of our federal government.

- We expect -- we have a right to expect -- federal market regulatory agencies (departments, boards, commissions, whatever) to promote the depth, the transparency and the certainty of counterparty performance in the markets subject to their charge.
- We expect -- we have a right to expect -- federal market regulatory agencies to foster evolution in market structure and in traded instruments for the more effective fulfillment of the function of those markets in the larger national economy.
- We expect -- we have a right to expect -- federal market regulatory agencies to accept intermarket competition and to utilize intermarket arbitrage as spurs to the marketplace success, or failure, of instruments (old or new) seeking to find and preserve a niche in those markets.
- We expect -- we have a right to expect -- federal regulatory agencies whose jurisdiction intersects or overlaps to coordinate their activities and to cooperate in securing the general welfare, which is their common goal.

Those expectations -- they are mine; I believe they are yours as well -- prompt me to raise three issues (and to state my conclusions on all three issues) that are fundamental, but peculiarly neglected, in the present debate.

First: exclusivity, in the sense of exclusion of marketplace competition, carries a heavy negative presumption in market regulation; it should require considered justification wherever it is applied, and renewed justification whenever it is extended. Exclusion of marketplace competition has proven very productive for standardized futures contracts --

that is, for bilateral obligations, satisfied by offset or delivery, undertaken principally to assume or shift price risk without title transfer. (That description is not proprietary, since it comes from the CFTC's December 1987 Advance Notice of Proposed Rulemaking.) By contrast, exclusion of marketplace competition has been recognized as clearly counterproductive, at least since 1975, in the equity securities markets. No market regulator, and no market provider, should have the capacity to extend the regime of monopoly trading, appropriate though it is for standardized futures contracts, into the markets for other instruments without discharging the burden of public explanation and public persuasion.

Second: innovative evolution in market structure and in traded instruments is the lifeblood of market survival; too often innovation is forced to proceed <u>despite</u> market regulators. Except for the limited area of "public safety" (that is, risk of damage to market participants), regulatory approval as a <u>pre</u>condition to market entry also carries a heavy negative presumption in market regulation. It is not regulatory approval but rather success or failure in the marketplace that is the proper standard for evaluation of market innovations. That standard precludes neither disclosure review (as in the securities context) nor economic purpose review (as in the futures context), but it does preclude the substitution of regulators' opinions for marketplace assessment.

Third: international competition for marketplace activity is keen in the 1990s. These United States take a back seat to noone in the vitality, depth and magnetism of our financial markets. It is folly to pursue <u>any</u> market regulatory policy (again save for the protection of "public safety") resulting in a prohibition of trading in our domestic financial markets -- a suffocation of development of innovative market instruments in our domestic financial markets -- that we can clearly see will simply cause that trading and the development of those instruments to move abroad.

The current Senate version of the CFTC Reauthorization Bill, S.207, freezes the interpretation of the Commodity Exchange Act's exclusivity clause where Judge Easterbrook left it two years ago. The effect is to ratify the imposition of exclusivity across the spectrum of hybrid instruments both existing and yet to be developed, to substitute regulatory agency pre-review and a limited possibility of pre-exemption in lieu of evaluation of these instruments by the marketplace, and to export markets in these instruments from the United States. That effect makes no regulatory-policy sense!

The form of amendment to S.207 advocated by the SEC, in coordination with other Administration and independent regulatory officials, would preserve exclusivity and Commodity-Exchange-Act-structured regulation for the traditional bilateral instruments where they have proven they serve well, would treat standard banking and insurance activities under their respective regulatory regimes, and would allow competition for marketplace and for regulatory structure, whether in banking, in insurance, in securities or in futures, for all other instruments. Similar instruments could trade, for example, on a national securities exchange and on a futures board of trade, subject to their respectively applicable regulatory regimes, and the arbitrage between them might well strengthen both. (The resulting regulatory competition is rather to be welcomed than feared; it could likely benefit us all.) Chairman Greenspan has put it this way: "It would be preferable to allow [hybrid] instruments to trade on markets selected by the parties. . . . In this way, owing to different customer bases, similar products could evolve in ways that best meet the needs of those customers."

As I said last summer, I, for one, don't believe that shuffling the deck chairs or reassigning the stewards is the solution to market regulatory problems. But I do believe, strongly, that the public interest particularly embraces the principles of federal market regulatory structure that underlie the choice between exclusivity and competition. And I

do believe that the presumption in favor of marketplace competition, the demand for hard evidence to justify substitution of regulatory opinion for success or failure in the marketplace, the insistence that we promote -- not export -- fair financial market activity of all kinds within the United States, and the concern against excess authority in market regulatory agencies already too far insulated from the process of public accountability -- which I hold key among such principles -- lead compellingly both to limiting the principle of exclusivity to the bilateral futures instruments that it well serves and to permitting the evolution of hybrid instruments in America's financial markets, under whichever regulatory regime best serves, for the benefit of us all.