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LOOKING BACKWARD AND FORWARD

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The views expressed herein are those of Commissioner Fleischman and do not represent those of the Commission, other Commissioners, or the staff.

It's been nearly six years since this rube of a New York lawyer made the trip to Washington for an oath-taking, and what an amazing six years they have been!! It's been four years minus only 2 days since the financial markets took their largest tumble in history. It's been three-and-a-half years since the Chairmen of the Federal Reserve system, the CFTC and the SEC, working with the Under Secretary of the Treasury for Finance, made public their Interim Report of the Working Group on Financial Markets (do you even remember it?). It's been three years and four months, or one year and seven months (depending on which occasion you choose), since the SEC decided to seek jurisdiction over the stock index futures markets. It's been the better part of a year since Leo Melamed and John Phelan bid their official adieux as senior officials of the Merc and the NYSE. It's been six full months since the CFTC Reauthorization Bill, including Title III, was passed by the Senate. It's been a mere three weeks since the Chairmen of the CFTC and the SEC, and the Secretary of Treasury, spoke -- albeit separately -- before the free world's financial market regulators gathered for the IOSCO annual meeting.

How much has transpired in my six years!! And how much we all can still learn from all that has happened!! These reflections are my effort to remind us of those lessons still to be learned, and to place them in the context of the demonstrated strengths, and the apparent weaknesses, of our American market regulatory system.

Prior to the 1987 market break, you may recall that the Fed, the CFTC and the SEC submitted to Congress a joint study addressing the then-evolving futures and options markets. The Joint Study concluded that:

1. the financial futures and options markets had provided mechanisms for risk transfer -- a market function considered likely to spread to additional participants and to increase in scope and volume;
2. those markets had enhanced liquidity in some underlying cash markets without measurable negative implications for capital formation or liquidity elsewhere;
3. harmonization of federal regulation of derivative, underlying and related markets was needed; and
4. the CFTC and SEC had committed to cooperation in establishing a compatible framework of regulation capable of dealing with all supervisory and regulatory needs in the markets.

Pause for a moment to examine a few of the implications of those conclusions: Issue #1 was economic purpose and conclusion #1 related to economic function. That alone spoke in a language measurably unfamiliar to at least one of the government regulators -- the SEC. Unlike the economic purpose test that has for fifteen years and more been part of the CFTC's requirements for contract market designation (although recently proposed to be abbreviated in view of the CFTC staff's "expertise to ascertain economic purpose [even] in the absence of an explicit written justification by the exchange"), no economic analysis was or is (or perhaps should be) required to justify acceptance of a new security for trading in the securities markets -- and quantitative economic analysis of the actual functioning of a new security instrument or an existing securities market was (and is) in the R & D stage at the SEC. You may well ask how a market regulatory agency, in 1984 or in 1991, can discharge its obligations without a proactive, effective, professional economics staff -- but (with the exception of a scant few years recently ended), the SEC undertakes to do just that.

Second (among the implications of the Joint Study's conclusions), risk transfer was a totally novel and little-comprehended notion when applied to the capital-formation and secondary markets in the securities field, while its correlative "price discovery" was already being performed by the securities markets and, from the vantagepoint of the SEC and the securities markets, would only be duplicated -- or, rather, aped -- in the derivative markets. I am reminded of a story from David Shipler's book ten years ago on Communist Russia under Brezhnev. Shipler wrote that, after an appearance in a city far from Moscow, two men approached him and one of them asked whether Americans carried "propuski" -- internal passports. When Shipler answered "No", the questioner turned to his companion and said, "You see, it's just as I told you; they are unable to travel from city to city in America." Just so, the Joint Study seems to have reflected joint agreement on the words, but no real communication on the substance.

When the market break brought us all up short less than three years later, the fundamental notions of risk transfer instruments and price discovery markets -- Futures 101, if you will, starting with the farmer and the miller -- had to be explained and re-explained to a disbelieving, noncomprehending group of securities law professionals well-versed in disclosure and capital formation practices and in antifraud and antimanipulative regulation but (for the most part) unaware either that sophisticated Participants in the capital formation process had been utilizing risk transfer instruments to hedge exposure for at least half-a-dozen years or that the movements of markets subject to manipulation were far more continuous and far less fearsome than unmanipulated movements toward a clearing price in an efficient price-discovery market. In other words, the SEC (and probably the Fed and the CFTC as well) was simply unaware of the extent of the invisible revolution that Chicago

had wrought vis-a-vis New York -- and of the extraordinary breadth of utility of risk-transfer instruments across the financial markets.

You see, in matters like those that were the subject of the Joint Study, the SEC knows that quantitative empirical evidence, gathered and analyzed in a rigorous professional manner, and applied against a protocol prescribed before the evidence is gathered (rather than after the evidence is in), would merely lengthen the regulatory process and ultimately (without doubt) confirm our a priori conclusions. Only once, in the case of NYSE Rule 80A, have we driven ourselves to require evidence of particular pre-prescribed market reaction with minimum pre-prescribed criteria for market performance. Just this past week the SEC recanted, refusing to apply the same protocol approach to NASD pilot rules. Unfortunately, the empirical analysis may not confirm our prejudgments; the economists may reach results that we lawyers, with one eye on the media and one eye on Capitol Hill, don't want to be saddled with. So we close our eyes and ears -- and cut off our economic hands. Did someone quote me as referring to the American Know-Nothings of 150 years ago? I wring my hands.

Last (among the joint study's implications), harmonization of regulation and cooperation in establishing effective framework were beset from the beginning by interagency rivalry and pride of place, not limited to either the SEC or the CFTC. When I got to Washington and met Kalo Hineman (and demonstrated some familiarity with futures trading and futures market structure and function), I appeared to be among the very first Fifth Street denizens since John Shad and Phil Johnson had met for lunch who cared to learn what was happening on Twenty-first Street across town.

And did I luck out!! I got an invitation from Kalo to attend one of the weekly staff briefings, reviewing extraordinary patterns of trading in the CFTC-overseen markets -- and my invitation, extended weeks earlier, was to attend the meeting to review trading during the week of October 19-23, 1987. That session was an eye-opener!! I may have learned more that morning, and I certainly watched more free-flowing professional Commission-to-staff and staff-to-Commission interaction and analysis that morning, than I learned or saw on that subject in the six months of study that followed.

One topic that I don't remember coming up at that meeting, and that I don't remember hearing about until several weeks later during a briefing by senior personnel of the SEC's Market Regulation staff, was EFPs. The CFTC staff had, only a few weeks before the crash, published its EFP study, with reference to both soft and hard commodities and even with reference to financial futures. As to stock indexes, the EFP study noted that the EFPs examined were "executed to facilitate arbitrage" but that "the number of stock index EFPs ... is inadequate to serve as a basis

for generalizations." We all should have noticed the potential lurking in a sentence elsewhere in the EFP study: "EFPs have become an increasingly common means to limit risk as a result of, or to participate in, price changes when domestic futures [and stock] exchanges are closed." (The emphasis is mine.) As usual, the market practitioners were ahead of the regulators, and, with a narrowing world, the market participants could transact EFPs abroad, in the early hours of a Monday trading morning, that might incidentally precipitate, as well as give them the option to participate in, trans-oceanic and intermarket price changes.

Somehow I've managed to get this far without mentioning either of the fighting words "margin" and "speculation". Both have been banners in the battles of 1988 and 1990 for reallocation of jurisdiction. For my purposes today, a review of the roles they have played is unnecessary. Rather, they point up the persistence of stereotypical misconceptions, particularly on Capitol Hill, when lay consciousness fails to keep pace with professional understanding. Whatever may have been the understandings and rallying cries, or even the realities, of 1933-1934, the role of securities market margin in pumping credit into the domestic economy had been substantially discounted by the Fed well prior to 1987, and the fear of the excesses of speculation had been balanced by a market understanding that speculation in the sense of informationless trading is an essential ingredient in providing market liquidity. (It was in fact the "speculators" who provided much of the buy-side, the long side, on Monday, October 19.) But most of Congress didn't understand that many senior regulators at the SROs and the SEC weren't au courant -- and few among those who were au courant realized the distinction between the role of margin in securities markets and the role of margin in daily-marked futures markets, or were cognizant that margin levels moved frequently in the futures markets to reflect volatility while the Fed had effectively stopped moving levels of margin in the securities markets some years before. The struggle simply to explain, to dispel misconceptions and to achieve comparisons of apples to apples, particularly as to margin, was a peculiarly difficult part of the 1987-1988 debate, which even the President's Working Group Report in May of '88 failed to accomplish.

The Working Group Report did, however, succeed in focusing attention on one phrase that always evoked knitted brows and heavy clouds of mixed tedium and esoterica. That phrase was "clearance and settlement". Among all the market participants and analysts, perhaps only John Davidson, Roger Rutz and Wayne Luthringhausen here in Chicago and Tom Russo and Dick Miller in New York (plus two or three others) had real insight not only into what was at stake (in terms of blood supply to the market's heart and limbs) but also into what the possibilities and consequences were for duplication, linkage, netting and offset in the several separate clearing and settlement mechanisms -- and certainly only they, at first, understood the market power that control over the clearance and settlement mechanisms bestowed.

It took only a short while, however, once market power was understood to be at stake, for the rest of us to decipher the Working Group's carefully stated concern that "uncertainty concerning [the] rights and obligations [of the various parties to the clearing and settlement process] ... could lead to unilateral actions that ... could adversely impact the willingness or ability of market participants to satisfy their own obligations." One translation: this issue is too important to become an interagency football. And in fact on clearing and settlement issues I believe there has been, as much as in any other single area, appropriate interagency coordination --- so Messrs. Davidson, Rutz, Luthringhausen, Russo and Miller are no longer the only savants who really understand.

From this relatively ancient history let me jump to the IOSCO presentations in Washington last month. Press reports indicate that Chairman Gramm spoke on the derivative markets and on the necessity of coordinated international regulatory structures that are tailored to the recognition and integration of the functions that risk-transfer markets perform, with and into the functions performed by the more traditional financial markets.

Secretary Brady, whose text was made publicly available, spoke on a broader-but-no-less-relevant topic: in general, the role of government regulation in free markets at a time when public belief in professional abuse of the largest financial cash market of all -- the primary market for U.S. Treasury securities -- has been radically heightened. Secretary Brady reminded his audience, at the start, that the flow of market activity, like quicksilver or water, will seek its own path and that an over-onerous regulatory hand will cause markets to work around it, work away from it, or not work at all. He called for use of the laboring oar to devise "sensible" regulations, resisting the temptation to "build our reputation as tough enforcers" in favor of elevation of compliance and administration of justice by "balanced and consistent regulators". I wholehearted and enthusiastically agree, and I understand how difficult it is to convey those messages in Washington.

Now, with your permission, I'll back up a bit in time to Title III of the Reauthorization Bill crafted by the CFTC and the Senate Agriculture Committee last winter and spring and passed by the Senate in April. I have nothing to say about the assignment (and delegability) of margin rule review authority in §301. You may know I think it's an appropriate balancing of interests. I would myself have righted the balance slightly closer to the contract markets, and a bit more directly involving the CFTC rather than the Fed, but I think §301 is pretty close on. Nor do I have anything to add to the debate on exemptive power in §302. Again, I would have bestowed fewer restrictions on the general permissive exemptive authority, and taken more of what's likely by way of future evolution into account, with respect to the

exemption mandated for swaps, but then I don't have a background at the CBT.

I do have something to say about the exclusion for certain hybrid instruments in §303 and the freeze on excluded IPs in §304, and I'll treat both together. The great pride of the Chicago markets, repeated articulately by Leo Melamed and often referred to by Professor Merton Miller and Fed Chairman Greenspan, is the receptivity to -- nay, the promotion of -- innovation in financial instruments. That innovation has continued even though the Chicago markets present the opportunity to open and close positions in standardized futures and options offset contracts only, and even though the Commodity Exchange Act requires that any futures contract be traded only on an exchange and that no option on a future can trade without meeting the conditions prescribed in CFTC rules.

We've now reached a fork in the road. Novel instruments with elements of futurity are being presented for trading elsewhere than on boards of trade and in a regulatory framework parallel to that of the CEA. For the greatest part, these are standardized but non-offset instruments with non-artificial resemblance to other instruments commonly known as securities. For my part, I concede to Chairman Gramm's position that the closer the resemblance to normal risk-transfer futures contracts, the stronger the logic for governance under the CEA. But I bridle at the 50% cut -- the "dominant strain" approach -- because I believe that the formulae to be applied cut off much run-of-the-mill medium-term and all long-term debt that happens to have an embedded or otherwise attached commodity option; because I know that no market participant with half a mind will go within 10%-15% of wherever the line is supposed to be drawn (since the risk of mistaken calculation is a legal guillotine), with the result that the bulk of all hybrids would be excluded from the exclusion; and, most of all, I bridle because I'm committed to the born-in-Chicago conviction that what counts is not success in the courthouse or at the regulator's desk but success -- or failure -- on the trading floor and at the trader's desk.

Now, this need not be a battle between regulatory regimes, regulatory agencies, or even marketplaces. Let me hazard some precepts -- and give you a bottom line.

1. The CEA, the CFTC and the boards of trade are the appropriate regulatory regime, regulator and marketplaces for future-oriented risk transfer instruments in general.
2. They should, therefore, have a call -- a right of first refusal, if you will -- on anything that is such an instrument but that also has securities characteristics making it distinguishable from a classical futures contract.

3. That call should not be so extensive or so exclusive as to pronounce the death sentence on any instrument for which the call has not been exercised. That is, there ought to be a way for an instrument that no board of trade wants to put up for trading, or that the members and customers of a board of trade don't want to bother with (perhaps along the lines of the so-called "low volume contracts"), to be put out for trading elsewhere, on a sink-or-swim basis.
4. The CFTC should have the last say if there is some larger market interest to be protected, so that some far-side instrument generally acknowledged to be deleterious to the markets can, with due process, be precluded from trading.
5. But ... bottom line: the American trading markets should not be deprived of the opportunity to vote innovations to the markets down (or up) with their hands, their fingers and their dollars, pounds, yen, francs and marks simply because it is disturbing or disadvantageous to a marketplace or a market regulator to allow those instruments to succeed or to fail on the basis of the economic attractiveness they present.

I don't believe it would be particularly hard to draft all this into statutory language -- and I don't think there's a prayer that it will happen. But floating against the tide no longer frightens me; there'll be another tide tomorrow -- and the good, the right, and the true will bob back to the surface again.

It's time to pull all these ramblings together. The perception gained from my six Washington years, and the perspective that comes from being a lame duck Commissioner who is still proud to be espousing the ideas and ideals of an era now gone, may be summarized this way:

- Washington-based, upwardly-mobile federal officials don't understand markets nearly as well as the governors and officials of the markets themselves. We're always (even the best of us, like Bill Heyman who's right out of the trading arena) behind in understanding the latest developments and trying to fathom the latest changes.
- Market regulators need a huge foundation of knowledge - - theoretical and applied -- about the markets they regulate, and can no longer (if they ever could) carve market regulatory policy into the clay of their own gut-driven insights. The successive awards of the Nobel Prize to market economists are but another manifestation of this truism. Market law has a

foundation of sand if it fails to rest firmly on economic analysis of markets.

- Risk transfer instruments and capital formation instruments (even when traded in the secondary markets) are different breeds, related to one another as any derivative instrument is related to the underlying, but best served by different regulatory structures with different market conditions and different market and regulatory attitudes. What's good in risk transfer markets is not necessarily good in securities markets, nor is what's evil in securities markets necessarily evil in risk transfer markets; clearance pricing may be unacceptable in one but ideal in the other. Nevertheless, neither market should be allowed to damage the other.
- Therefore, cross-market mechanisms agreed on between the boards of trade and the stock exchanges, and inter-agency consultation and cooperation on issues as contentious as margins and as concordant as customer protection, are absolutely essential. If, in fact, there has to be a referee, "the Secretary of Treasury or his delegate" (in the hallowed Internal Revenue Code phrase) has been personally chosen by the President to be responsible for national financial policy. But a referee shouldn't be needed. Consultation and cooperation are an acquired habit -- try them; they grow on you; and, when sufficiently ingrained, they may just be able to compete with the Washington tendency (that I certainly acknowledge) to put parochial "turf" interests above the interests of the national financial markets and of the investing and hedging public.
- It's still the nitty-gritty of clearance and settlement -- the subsurface plumbing of the market system -- that cries out loudest for attention. As the market world gets more international, the old issues get more pressing, with even more potential for problems. I see that one of my colleagues has told the Group of Thirty that efforts to do away with physical evidences of securities will go nowhere at the SEC. If I were on the Group of Thirty, I'd say, "Shiver the SEC." But inter-clearinghouse guaranties, cross-margining and multiparty netting will ultimately be developed by some markets even if others refuse -- and the devil take the hindmost. Systemic risk is the one hobgoblin that no market participant, and no market regulator, can abide.
- Peculiarly, I'm a believer in market responsibility, too. Somewhere, somehow, it's not enough just to take the good times. There's a price to pay to be on the floor, whether in New York or Chicago, and that price

(as I see it) has to be some obligation under some circumstances to lean against the wind.

And I'm clearly a believer in the value of innovation. I won't argue whether more, and more qualitative, innovation has come from Chicago in the last two decades than from New York -- from the risk transfer markets rather than from the securities markets. Innovation must not be allowed to stagnate. The futures markets are too vital, too competitive, to insist that the table is full and that no one else can play at any other table. Let the hedgers and speculators decide whether in their view the new instruments are worth using -- or are not. If any new instrument which is traded elsewhere than on the boards of trade is worth using, the markets will find a way to substitute an economic equivalent at the Merc or the Board of Trade -- or perhaps in Kansas City, Minneapolis or even New York.

Finally, we do need the likes of Leo Melamed and John Phelan, who are market leaders because they know the markets in their bones, and market statesmen because they have the greater vision to see beyond the immediate concerns. We do need consistent and balanced regulators, to repeat Secretary Brady's words, to safeguard the public interest and the interests of the markets themselves. We do need to take our Grail (not the achievable but the perhaps-always-just-beyond-our-reach) from Nobel Laureate Professor Coase's work: the constant effort to make the complementary financial markets of this country function more and more efficiently with less and less government regulatory intervention -- for the benefit not only of the professional market participants or even the millions of direct and intermediated market users, but for the benefit of the American and worldwide public the quality of whose lives, even when it is least understood, is intimately tied to the proper functioning of free markets everywhere.