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Statement of the Shadow Financial Regulatory Committee

on

**Proposals to Consolidate
the SEC and CFTC**

May 7, 1990

H.R. 4477 proposes the creation of a single agency, to be called the Markets and Trading Commission, which would oversee securities and futures markets and would set margin requirements on all securities, options and futures contracts. The proposed super-regulatory agency would replace the Securities and Exchange Commission ("SEC") and the Commodity Futures Trading Commission ("CFTC") in regulating securities, futures, options, and any new products which are a hybrid of these instruments.

Other less sweeping proposals would enlarge the jurisdiction of the SEC at the expense of the CFTC by, at a minimum, transferring jurisdiction over stock index futures, and options on such futures, to the SEC.

SUPPORTERS INCLUDE

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INSTITUTE FOR
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The Shadow Financial Regulatory Committee believes that proposals to consolidate regulators should be carefully scrutinized and should meet the burden of showing that such consolidation is in the public interest.

In general, the Committee believes that markets not governed by a monolithic regulatory structure display greater innovativeness and greater competitive creativity than do markets in which firms can operate under one of several regulators. This has been true for U.S. financial markets during the past two decades. U.S. financial markets have been among the most innovative in the world, and futures markets have provided us with some of the most successful innovations. Stock index futures, T-bond futures, Eurodollar futures, currency futures, and energy futures have proved to be immensely useful to all kinds of financial and non-financial firms. The Committee believes that, given the SEC's past record, it is highly unlikely that these products and markets would have been born had the SEC had sole jurisdiction over futures markets.

Merging the SEC and the CFTC threatens to inhibit the innovative responsiveness of U.S. securities and futures markets, and, ultimately, to put U.S. financial markets at a competitive disadvantage internationally.

It is important, therefore, that those who support merger proposals demonstrate that there are significant benefits to consolidation. The Committee wants to emphasize that this has not been done.

Supporters of the proposed change in regulatory jurisdiction have not made clear exactly what problems would be alleviated by the shift in jurisdiction. The allegations include:

-- Stock index futures and related trading strategies, such as stock index arbitrage, have caused excess volatility in the stock market and have driven small investors from the stock market;

-- Low margins on stock index futures have caused stock market volatility and are a source of potential instability;

-- Separate and independent regulators cannot effectively monitor and police "intermarket frontrunning" involving both securities and futures markets;

-- The present fragmented regulatory structure in the U.S. puts the U.S. at a competitive disadvantage in international negotiations with regulators from other countries; and

-- The present fragmented regulatory structure is stifling competition and innovation.

The Committee rejects these allegations. Moreover, a shift of jurisdiction to the SEC would not address the alleged problems.

There is little evidence to support the contention that the trading of stock index futures is responsible for increased stock market volatility. Studies of stock market volatility have found that such trading is not the responsible factor. Similarly, there is no evidence to suggest that small investors have been "driven" from the market by stock index futures trading. There is also no evidence that stock index arbitrage has increased stock market volatility.

The view that low margins on stock index futures are the cause of increased volatility and of greater instability is without merit. Almost all studies, including a study by the Federal Reserve Board's own staff, have concluded that low margins have no relationship to volatility or market instability. The Committee is amazed that some regulators and government officials continue to make this argument in the face of overwhelming evidence to the contrary.

The Committee wishes to note that in a previous statement on the Brady Commission report (Statement, No. 33, May 16, 1988) it expresses similar conclusions about margins and stock index futures trading. At that time criticisms of stock index futures trading and low

futures margins were propounded by the Brady Commission. The same views are now being advanced by the U.S. Treasury under Secretary Brady. Since the Brady Commission report there have been additional studies that confirm the Committee's views and not those of Secretary Brady.

On the issue of intermarket frontrunning involving futures markets, there is no evidence that this is indeed a significant problem, or that it is any more of a problem than is frontrunning between the stock and options markets, which are already under the single jurisdiction of the SEC. In addition, recent regulations and regulatory arrangements among exchanges and the SEC and the CFTC have been instituted to police and control this practice. If these provisions are not adequate, we need to know in what ways they are deficient so that a remedy can be fashioned. Regardless, it is not obvious how a merger of the SEC and CFTC would be responsive to this issue.

It is also unclear how the present regulatory structure prevents the United States from successfully negotiating with foreign regulators. Both the SEC and CFTC have recently concluded agreements with foreign regulators.

The charge that the CFTC now stands in the way of competition and innovation is, at best, ironic. Not too

long ago critics of the CFTC contended that the agency was fostering "excessive" innovation and competition: there were, allegedly, too many new products and too much competition.

To conclude, the Committee cannot identify any serious problems that will be remedied by a shift in regulatory jurisdiction to the SEC. The current regulatory framework has fostered a competitive and innovative financial system. While some regulatory inefficiencies may exist, these are a small price to pay for the innovative markets we have developed. Before doing major surgery on a seemingly healthy patient, it is important to be sure that the surgery promises to accomplish something beneficial.