


MEMORANDUM

TO : Chairman Ruder  
Linda Fienberg  
Alden Adkins  
Rick Ketchum  
Mark Fitterman  
Brandon Becker  
Howard Kramer

FROM : Nina Gross 

DATE : March 11, 1988

RE : Speech of Senator Pat Leahy

Yesterday, March 10, 1988, Senator Leahy spoke before the Futures Industry Association at their annual convention, in Boca Raton, Florida. Attached please find a copy of the speech which will give us an indication of the approach and the type of questions the Senator will ask at next Thursday's hearing before the Senate Agriculture Committee on the Market Break. (I have underscored some key parts of the speech).

I have also attached a copy of Senator Leahy's proposed legislation to establish an Intermarket Monitoring Council.

Attachment

# U.S. SENATOR PATRICK LEAHY

VERMONT

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## REMARKS OF SENATOR PATRICK LEAHY BEFORE THE FUTURES INDUSTRY ASSOCIATION

MARCH 10, 1988.

NEXT FRIDAY, MARCH 19 WILL BE THE FIVE MONTH ANNIVERSARY OF THE MARKET EVENTS THAT ROCKED THE WORLD FINANCIAL SYSTEM. SINCE THAT TIME, WE HAVE SEEN AT LEAST A HALF DOZEN MAJOR EXPERT STUDIES ON THE MARKET BREAK.

WE NOW MEASURE THESE REPORTS IN FEET RATHER THAN INCHES OF PAPER. THE MOST PRESTIGIOUS OF THESE REPORTS, THE PRESIDENTIAL TASK FORCE ON MARKET MECHANISMS (THE BRADY COMMISSION REPORT), RECEIVED GREAT ATTENTION ON CAPITOL HILL AND WIDE COVERAGE IN THE POPULAR PRESS. THE OCEANS OF NEWSPAPER INK AND WAVES OF TELEVISION AND RADIO COVERAGE ALL OFFER ANALYSES AND EXPERT ADVICE ON HOW TO CHANGE OUR TRADING SYSTEM.

TO GIVE BUT ONE BRIEF EXAMPLE, THE WASHINGTON POST EDITORS STUDIED ALL OF THE REPORTS, LISTENED TO ALL TESTIMONY, SORTED THROUGH ALL OF THE COVERAGE, HOSTED MR. PHELAN FOR LUNCH, AND CONCLUDED THAT CHAIRMAN RUDER WAS RIGHT -- STOCK INDEX FUTURES OUGHT TO BE REGULATED BY THE SEC. WHAT I FOUND FASCINATING WAS THEIR REASONING. LET ME QUOTE.

"SEC'S PROPER CONCERN IS SECURITIES, AND THE CFTC'S IS COMMODITIES. STOCK INDICES ARE NOT COMMODITIES."

I GUESS ONCE THE POST FIGURES OUT THAT THE CFTC DOES NOT REGULATE COMMODITIES, THEY'LL PROPOSE THAT AG FUTURES BE SENT BACK TO USDA, OIL FUTURES TO THE DEPARTMENT OF ENERGY, GOLD COULD GO TO TREASURY AND I'M STILL PUZZLING OVER WHO WOULD REGULATE THE CPI CONTRACT.

PERHAPS EVEN MORE DISTURBING ARE THOSE IN BOTH THE POLITICAL AND FINANCIAL COMMUNITIES WHO DON'T EVEN MAKE A PRETENSE OF TRYING TO STUDY AND ANALYZE THIS COMPLEX SUBJECT. BY THE MORNING OF OCTOBER 20, THIS CROWD ALREADY KNEW WHAT THE PROBLEMS WERE AND HOW TO FIX THEM. I MIGHT ADD THAT A REVIEW OF THE FACTS DOES NOT SEEM TO HAVE CLOUDED THEIR UNDERSTANDING OR ALTERED THEIR PRESCRIPTIONS.

PERHAPS IT'S MY CONSERVATIVE VERMONT UPBRINGING BUT I THINK THAT BEFORE DECIDING WHAT OUGHT TO BE DONE, IT MAKES SENSE TO UNDERSTAND WHAT HAS HAPPENED. THAT'S WHY I'VE SPENT THE LAST SEVERAL MONTHS REVIEWING THESE REPORTS, TALKING TO THE EXPERTS, SOLICITING SUGGESTIONS, AND ASKING QUESTIONS OF PEOPLE IN THE AFFECTED INDUSTRIES.

I WANT TO TELL YOU WHAT I'VE CONCLUDED TO DATE, WHAT I THINK SHOULD BE DONE, WHAT SHOULDN'T BE DONE, AND WHAT MIGHT HAPPEN.

LET ME START WITH THREE BRIEF GENERAL POINTS:

FIRST, I ACCEPT THE BRADY COMMISSION'S ONE MARKET THEORY. IT'S ALSO ACCURATE TO SAY THAT WE HAVE A LINKED, GLOBAL MARKET FOR STOCKS, STOCK OPTIONS, STOCK INDEX FUTURES AND STOCK INDEX OPTIONS. AT SOME LEVEL, I THINK WE ALL KNEW THAT BEFORE THE REPORT. BUT WHAT SENATOR BRADY AND THE COMMISSION DID WAS TO FORCE ALL OF US TO BETTER UNDERSTAND THE IMPLICATIONS FOR REGULATORS, EXCHANGES, TRADERS, AND CUSTOMERS.

IT'S IMPORTANT TO UNDERSTAND THESE ISSUES BETTER BECAUSE THERE IS NO TURNING BACK. WE CAN'T UNPLUG THE COMPUTERS. WE'RE NOT GOING TO DELIST THE PRODUCTS. IF ANYTHING, WE'LL KEEP ADDING TECHNOLOGY AND COMPLEXITY, AS WHEN STOCK INDEX FUTURES CONTRACTS BEGIN TRADING IN TOKYO.

SECOND, WE WON'T TURN BACK BECAUSE STOCK INDEX FUTURES AND OPTIONS ARE IMPORTANT NEW TOOLS FOR FINANCIAL MANAGERS. THEY HAVE A POSITIVE EFFECT ON THE STOCK MARKETS AND THE ECONOMY IN GENERAL. THESE DERIVATIVE PRODUCTS ADD LIQUIDITY TO THE MARKETS, SPREAD RISK, SPEED UP PRICE DETERMINATIONS AND PERMIT MANAGERS OF STOCK PORTFOLIOS TO PROTECT THE VALUE OF THEIR INVESTMENTS. THESE ADVANTAGES HELP MORE THAN THE SOPHISTICATED TRADERS. THEY AID CAPITAL FORMATION AND BENEFIT THE AVERAGE CITIZEN WHO SHARES IN THESE MARKETS THROUGH MUTUAL AND PENSION FUNDS.

THIRD, THE FEDERAL REGULATORS, THE EXCHANGES AND MOST OF THE MARKET PARTICIPANTS CAN BE PROUD OF THE ACTIONS THEY TOOK WITHIN THEIR OWN MARKETS. WHILE THERE ARE SOME NOTABLE EXCEPTIONS DOCUMENTED IN THE COMMISSIONS' STUDIES, MOST MARKET

PARTICIPANTS PERFORMED ADMIRABLY DURING THE CRISIS. THE CFTC, THE SEC AND ESPECIALLY THE FEDERAL RESERVE BOARD DID A TERRIFIC JOB OF RESPONDING TO THE CRISIS.

BUT NO ONE SHOULD TAKE MUCH PRIDE IN HOW INTERMARKET PROBLEMS WERE IDENTIFIED AND HANDLED BEFORE, DURING, AND AFTER THE CRASH. THE FEDERAL REGULATORS OFTEN FAILED TO PLAN, THE EXCHANGES OFTEN FAILED TO TALK, AND THE WHOLE SYSTEM INDULGED IN MORE CARPING THAN COOPERATION. THE ATMOSPHERE HAS IMPROVED SOMEWHAT, BUT MORE NEEDS TO BE DONE. WHICH BRINGS ME TO MY NEXT POINT -- WHAT SHOULD MARKET PARTICIPANTS, REGULATORS AND CONGRESS BE DOING NOW.

FIRST, WE ALL SHOULD REJECT THE NEW REVISIONISM WHICH CONCLUDES THAT THERE WAS NO PROBLEM--THAT THE MARKETS WORKED THE WAY THEY WERE SUPPOSED TO, FINDING THEIR APPROPRIATE LEVEL, ALBEIT AT RATHER BREATHTAKING SPEED.

DURING THE WEEK OF OCTOBER 19, THE MARKETS WERE OUT OF CONTROL AND ON THE VERGE OF COLLAPSE. THERE WERE REAL SYSTEMIC PROBLEMS THAT WEEK WHICH DESERVE SERIOUS SOLUTIONS.

THE AGENCIES AND SRO'S NEED TO MOVE RAPIDLY TO IMPROVE AND COORDINATE INFORMATION SYSTEMS. THE CFTC AND FUTURES EXCHANGES DEMONSTRATED THE QUALITY OF THEIR SURVEILLANCE SYSTEMS IN OCTOBER. THE SAME CANNOT BE SAID OF THE SEC AND THE NEW YORK STOCK EXCHANGE, BUT THE POINT NOW IS NOT TO BLAME BUT TO IMPROVE, AND TO CREATE SYSTEMS WHICH CAN EFFECTIVELY PROVIDE SURVEILLANCE OF MARKETS AND FINANCIAL POSITIONS ACROSS THE VARIOUS MARKETS.

SPECIALIST CAPITAL POSITIONS NEED TO BE IMPROVED, BUT BEFORE WE CAN DO THAT WE NEED TO KNOW WHAT THEY ARE. I WAS SURPRISED TO LEARN THAT SPECIALISTS WERE EXEMPTED BY THE SEC FROM FILING QUARTERLY FINANCIAL STATEMENTS OR FOCUS REPORTS. THE COMMISSION CHOSE INSTEAD TO RELY ON NYSE STATISTICAL ANALYSES OF AGGREGATE DATA. THAT, IN MY VIEW, SHOULD BE CORRECTED IMMEDIATELY.

ON THE FUTURES SIDE, MARGIN ON STOCK-INDEX CONTRACTS CONTINUES TO BE A THORNY ISSUE.

IT'S TRUE THAT MARGIN PLAYS A DIFFERENT ROLE IN FUTURES MARKETS THAN IN STOCKS. IT'S TRUE THAT THE MAINTENANCE MARGIN AND THE MARKED TO MARKET SYSTEM WORKED DURING THE CRISIS. IT'S TRUE, THAT IF LOOKED AT OVER A COMPARABLE FIVE DAY PERIOD BEGINNING ON OCTOBER 19, STOCK AND FUTURES MARGINS WERE PRETTY COMPARABLE. BUT I BELIEVE THAT IT IS ALSO TRUE, AS THE BRADY COMMISSION POINTED OUT, THAT FUTURES TRADING CAN ACT AS A SUBSTITUTE FOR STOCK TRADING. INITIAL MARGINS THAT ARE TOO LOW, AS THEY WERE LEADING INTO OCTOBER 19TH, CAN SPUR UNHEALTHY SPECULATION AND OVERINFLATING OF THE STOCK MARKET. WHAT BOTHERS ME IS THAT THE FUTURES COMMUNITY REFUSES TO ACKNOWLEDGE THAT.

THE CURRENT HIGHER INITIAL MARGIN REQUIREMENTS IMPLEMENTED BY THE EXCHANGES ARE A GOOD FIRST STEP. GIVEN THE DIFFERENT SYSTEMS, THEY MAY BE COMPARABLE TO STOCK MARGINS. MORE ANALYSIS ON THAT QUESTION NEEDS TO BE DONE. BUT UNLESS THE FUTURES EXCHANGES RECOGNIZE THE LINKAGE AND COMMIT THEMSELVES TO THE NOTION OF COMPARABILITY, THE PRESSURE WILL GROW IN THE CONGRESS TO SHIFT MARGIN SETTING AUTHORITY TO THE FED.

THE NEW YORK STOCK EXCHANGE HAS A FEW THINGS TO THINK ABOUT AS WELL. FOR EXAMPLE, I HOPE THEY FINALLY GET AROUND TO FOLLOWING UP ON THE GAO'S RECOMMENDATION THAT THEY CONDUCT AN OUTSIDE ASSESSMENT OF THEIR COMPUTER SYSTEMS. AND IF THEY INTEND TO IMPLEMENT THEIR DECISION TO BAN THE USE OF SUPER DOT FOR INDEX ARBITRAGE ON DAYS WHEN THE DOW MOVES 50 POINTS, THEY MIGHT WANT TO THINK OF A WAY OF MONITORING COMPLIANCE BY A MEANS OTHER THAN THE HONOR CODE, WHICH IS WHAT THEY TOLD THE GAO THEY WOULD RELY ON.

I APPLAUD THE NEW SPIRIT OF DETENTE BETWEEN THE EXCHANGES, WHICH, FIVE MONTHS AFTER THE CRASH, HAS FINALLY RESULTED IN PLANS TO INSTALL A HOT LINE FOR BETTER COMMUNICATION DURING A CRISIS.

EVEN MORE IMPORTANT THAN COOPERATION BETWEEN THE EXCHANGES, WE MUST DEMAND INCREASED COORDINATION AMONG THE REGULATORY AGENCIES. AGAIN, THERE ARE SOME POSITIVE SIGNS -- MEETINGS, PRELIMINARY NEGOTIATIONS ON CONTINGENCY PLANNING AND THE LIKE. BUT I WOULD HOPE THAT THE PACE WOULD QUICKEN. MUCH NEEDS TO BE DONE BY THE FED, THE CFTC, THE SEC, AND I THINK I WOULD ADD THE TREASURY DEPARTMENT, WORKING TOGETHER.

I'VE ALREADY MENTIONED IMPROVING INFORMATION AND SURVEILLANCE SYSTEMS.

THE AGENCIES OUGHT TO BE WORKING NOW ON A COORDINATED STRATEGY TO WRITE A CLEAR BAN ON INTERMARKET FRONTRUNNING AND TO PROSECUTE CASES WHERE THEY OCCUR.

THE AGENCIES NEED TO STUDY UNIFYING CLEARING SYSTEMS THROUGH APPROPRIATE LINKAGES AND CROSS MARGINING. THEY SHOULD RECOMMEND REGULATORY AND STATUTORY CHANGES IF THEY CONCLUDE, AS THE BRADY COMMISSION DID, THAT A UNIFIED SYSTEM MAKES SENSE.

THEY SHOULD, OF COURSE, PROCEED WITH CRISIS CONTINGENCY PLANNING AS THE GAO SUG-

GESTED. I'VE ASKED THE GAO TO REPORT BACK TO OUR COMMITTEE BY THE END OF APRIL WITH THE AGENCIES' PROGRESS IN THAT REGARD.

BUT I WOULD CAUTION THE AGENCIES NOT TO SPEND ALL OF THEIR COOPERATIVE EFFORTS ON PLANNING FOR A DISASTER AT THE EXPENSE OF SPENDING TIME PUTTING SYSTEMS IN PLACE WHICH COULD AVERT THE DISASTER. BOTH EFFORTS MUST PROCEED SIMULTANEOUSLY.

THE AGENCIES, WORKING TOGETHER, SHOULD ALSO USE THEIR COLLECTIVE AUTHORITY AND EXPERTISE TO TAKE THE LEAD WITH FOREIGN REGULATORS TO ACCOMPLISH MANY OF THE SAME GOALS AT THE INTERNATIONAL LEVEL.

\* FINALLY, I WANT TO MENTION ONE IDEA WHICH I BELIEVE SHOULD NOT BE PURSUED, THAT IS, CHAIRMAN RUDER'S SUGGESTION THAT AUTHORITY FOR REGULATING STOCK INDEX FUTURES BE TRANSFERRED TO THE SEC. MY OPPOSITION MAY SEEM PREDICTABLE, BUT I MUST TELL YOU THAT I DID GIVE FAIR CONSIDERATION TO THE MERITS. THE PROPOSAL IS NOT, AS SOME HAVE SUGGESTED, A BAD IDEA BECAUSE IT'S POLITICALLY UNFEASIBLE. IT'S POLITICALLY UNFEASIBLE BECAUSE IT'S A BAD IDEA.

FIRST, IT'S IMPORTANT TO SAY ONE MORE TIME THAT THE WASHINGTON POST IS WRONG. STOCK INDEX FUTURES ARE FUTURES NOT STOCK. AND THEY SHOULD BE REGULATED UNDER A REGIME DESIGNED FOR FUTURES REGULATION.

THERE ARE INTERMARKET ISSUES THAT NEED FIXING, BUT THIS ISN'T THE WAY TO DO IT.

\* SECOND, IN ATTEMPTING TO ADDRESS INTERMARKET PROBLEMS, THE RUDER PROPOSAL JEOPARDIZES A STRONG SYSTEM OF INTRAMARKET REGULATION. THE CFTC DOES A GOOD JOB OF REGULATING THE MARKETS UNDER ITS JURISDICTION. THE COMMISSION UNDERSTANDS THE OPEN OUTCRY SYSTEM. THEY HAVE IMPLEMENTED A TOUGH AUDIT TRAIL SYSTEM. THEY HAVE PROTECTED CUSTOMERS AND ATTACKED ABUSIVE TRADING PRACTICES. IF ANYTHING, IT'S THE SEC THAT TENDS TO IGNORE ITS OVERSIGHT OF THE DERIVATIVE MARKETS UNDER ITS JURISDICTION. OPTIONS ON STOCKS AND STOCK INDICES ARE WHERE THE VAST BULK OF CONSUMER COMPLAINTS COME FROM, NOT ON THE FUTURES SIDE. THESE OPTIONS FALL WITHIN THE PURVIEW OF THE SEC.

FINALLY, THE PROPOSAL ALMOST CERTAINLY WOULD RESULT IN DOUBLE REGULATION: DOUBLE REGULATION OF EXCHANGES, DOUBLE REGULATION OF TRADERS, CONFLICTING SURVEILLANCE AND AUDIT TRAIL REQUIREMENTS, CONFUSION OVER THE APPROPRIATE RULES GOVERNING PRIVATE CAUSES OF ACTION. I COULD GO ON.

SO WHAT'S MY PREDICTION FOR THIS YEAR? I WON'T TRY TO PREDICT THE MARKETS. THAT'S YOUR JOB. BUT I WILL MAKE A FEW PREDICTIONS ABOUT CAPITOL HILL.

FIRST, MY COMMITTEE WILL CONTINUE TO APPROACH THESE ISSUES IN A THOROUGH AND COMPREHENSIVE WAY. WE HAVE AN INITIAL HEARING ON MARCH 17TH AT WHICH SENATOR BRADY, CHAIRMAN RUDER, CHAIRMAN GRAMM AND COMMISSIONER HINEMAN WILL TESTIFY. OTHER HEARINGS WILL BE SCHEDULED IN LATE APRIL TO HEAR FROM THE GAO, THE EXCHANGES AND OTHER MARKET PARTICIPANTS INCLUDING THE USERS OF DERIVATIVE PRODUCTS. SENATOR PROXMIRE AND CONGRESSMAN MARKEY HAVE SCHEDULED ADDITIONAL HEARINGS LATER THIS MONTH. SO IT'S HARD FOR ME TO IMAGINE THAT ANY IMPORTANT QUESTION WILL GO UNASKED.

SECOND, I AM PREPARED TO INTRODUCE LEGISLATION TO CREATE AN INTERMARKET COORDINATING COUNCIL TO REQUIRE FEDERAL REGULATORS TO COORDINATE AND COOPERATE ON THE INTERMARKET ISSUES WHICH I OUTLINED ABOVE. I CIRCULATED A DRAFT OF THIS BILL TO THE REGULATORS. I AM WAITING FOR THEIR RESPONSE AND WAITING TO SEE IF THEY CAN ACCOMPLISH THE GOALS OF THE BILL ON THEIR OWN, WITHOUT LEGISLATION. BUT AT THIS POINT, I HAVE THE FEELING THAT THEIR ATTEMPTS TO COOPERATE REMIND ME SOME OF THE SMOKER WHO KNOWS HE HAS TO QUIT BUT DECIDES TO TRY LOW TAR CIGARETTES FIRST. ONE CAN APPLAUD THEIR RECOGNITION THAT SOMETHING NEEDS TO BE DONE BUT STILL BE TROUBLED BY THE FULL COMMITMENT TO THE GOAL. IF THEY DO NOT MOVE RAPIDLY, I INTEND TO PUSH FORWARD WITH THIS LEGISLATION.

OTHERS WILL HAVE DIFFERENT APPROACHES. SOME ON THE SENATE BANKING COMMITTEE WILL WANT TO ADOPT CHAIRMAN RUDER'S PROPOSAL TO MOVE REGULATION OF STOCK INDEX FUTURES TO THE SEC. OTHERS, ESPECIALLY IN THE HOUSE, MAY HAVE MORE DRASTIC IDEAS FOR REFORM.

GIVEN A SHORT SESSION, THE CAMPAIGNS, THE LACK OF CONSENSUS ON ANY SPECIFIC PROPOSALS AND THE NUMBER OF PLAYERS INVOLVED, THE CONVENTIONAL WISDOM--THAT NO SIGNIFICANT LEGISLATION ADDRESSING THIS TOPIC WILL PASS THIS YEAR--IS PROBABLY CORRECT.

BUT THAT DOESN'T MEAN THAT THESE QUESTIONS FADE INTO THE BACKGROUND. THOSE OF US IN INDUSTRY, IN THE EXCHANGES, IN THE GOVERNMENT, AND THE CONGRESS, MUST AND WILL MAKE SURE THESE ISSUES ARE ADEQUATELY ADDRESSED. YOU CAN BE CERTAIN WE WILL BE VIGILANT TO PROTECT INVESTORS, TO MAINTAIN ORDERLY MARKETS, AND TO IMPROVE AND EXPAND THE ECONOMIC PERFORMANCE IN THE UNITED STATES.