SECURITIES/FUTURES EXCHANGES AS EXAMPLES OF SELF-REGULATION

CHAIRMAN JAMES: Our next panel is entitled Securities and Future Exchanges as Examples of Self-Regulation. This panel was recommended to us by Commissioner Richard Leone, and I now invite Commissioner Leone to give a brief introduction to financial markets in the context which we will hear about those this morning.

Commissioner Leone, thank you very much.

COMMISSIONER LEONE: I will not be able to fulfill that charge, but I have been pressing, and with these distinguished panelists I know the subject will be covered, for us to talk about what we can learn from securities markets. Because my own experience working in that industry raised in my mind a variety of questions.

Securities markets exist to permit us to efficiently, more efficiently allocate capital. But they are in a way an admission of the fact that we can't make those decisions with great certainty. We rely on markets to correct for all the uncertainty. We rely on markets to shift risk. That's what hedging is all about. But markets do not eliminate the risk. Somebody takes on the risk. And sometimes people take on too much risk and in the period of the Great Depression where we did a great many things; both social insurance and changed financial markets in order to deal with the catastrophe that could occur if risk was taken to its logical extreme. We created a regulatory structure which has a few simple principles, a very complicated elaborate regulatory structure, but based on a few simple principles, that seem to me to be principles entirely lacking in

much of the gambling industry, the most obvious being disclosure of the risks. The most obvious place where that is not done is in state lotteries in any way.

The second is we have suitability requirements. We look at and require certain things about who is permitted to be in certain markets. As a former president of a commodities exchange, it's one of the riskiest of markets. That is a matter of serious concern. And we have a variety of mechanisms to insure that losses are guaranteed by clearing members or others or that there are credit controls, and we apply these rules to individuals, even to institutions.

So while the securities markets are not in the strict sense of the word "gambling", they've been ruled by Courts not to be gambling and they provide an economic function that is far different from the economic function that gambling provides. Gambling is a service in economic terms. Obviously it produces jobs and income for some people at a cost to other people who buy it just like any other service.

Capital markets serve a more fundamental purpose in a capitalist society. They enable people to turn to the capital markets in order to expand their activities and they provide rewards for the people who support that expansion either through equity or debt. Nonetheless, they involve a lot of uncertainty and risk and in some markets, commodities being the obvious example since we're here in Chicago, most investors lose their money. An overwhelming number of individual investors lose their money in those markets.

Even in the tried and true equity markets, investors do not as a group get the returns of the index because there are

transaction costs. While futures are a zero sum game, stocks are not a zero sum game, but both of them have transaction costs. So futures is quite like gambling in one sense in that there is some gain, minus the transaction cost and also given the way random numbers work, some people tend to lose a lot or win a lot. In the equity market the same thing is true.

In other words, I know many people, including many of my friends in the securities industry, didn't want anything to do with this Commission because they didn't want to be seen as having anything to do with gambling. Speculation serves an honorable function in capital markets and is regulated in a variety of ways. I also would argue from personal experience that a lot of what is called hedging is speculation when you look at it closely. And those markets, because we depend on them so much, are highly regulated and controlled by the government and by self-regulatory organizations and by brokers, all of whom have levels of rules and regulations.

I think we can learn a lot. I'm delighted that we have a panel like this. I can only say in conclusion that during 1987, after the stock market crashed, -- I was working for Nick Brady, who was chairman of the commission that looked into it, the stock market crash, and the various proposals to put sand in the wheels and other things. It became clear that a great many important people in the securities market did not understand the risks involved in a lot of the new securities or even plain vanilla ones like futures and options, let alone derivatives, people who were running firms, people who were very important in Washington. So it would not be surprising if a great many people did not understand the risks involved in being in the gambling

business and increasing numbers of people are in it, either as customers or as communities or as corporations. So I think this is a useful panel and I'm glad they're here.

CHAIRMAN JAMES: Thank you. Before I introduce our panel, I would like to take this opportunity to inform each of them that under the supplemental rules of the Commission, testimony before the Commission shall be considered to be conducted under oath. I'd like to introduce our distinguished speakers. The Honorable David Ruder, professor and former Dean of the Northwestern University School of Law. He's the former chairman of the United States Securities and Exchange Commission. Mr. Alton Harris is a renowned expert in the area of securities law and regulation. I'd like to thank you both for joining us this morning.