

Politics of the Brady Report: A Comment

Roberta Romano

Follow this and additional works at: <http://scholarship.law.cornell.edu/clr>

 Part of the [Law Commons](#)

Recommended Citation

Roberta Romano, *Politics of the Brady Report: A Comment*, 74 Cornell L. Rev. 865 (1989)

Available at: <http://scholarship.law.cornell.edu/clr/vol74/iss5/4>

This Article is brought to you for free and open access by the Journals at Scholarship@Cornell Law: A Digital Repository. It has been accepted for inclusion in Cornell Law Review by an authorized administrator of Scholarship@Cornell Law: A Digital Repository. For more information, please contact jmp8@cornell.edu.

THE POLITICS OF THE BRADY REPORT: A COMMENT

Roberta Romano †

I'd like to thank Jon Macey and the Cornell Law School and Law Review for organizing an interesting conference. I will keep my comment brief for two reasons: it's late in the day and I do not have many points of deep disagreement with David Haddock's paper.

Let me say at the outset that I agree with Dave's fundamental point—that the Brady Report on the October 1987 market crash is best understood as a *political* document, rather than as a policy prescription grounded in positive economic research. I also found the Report quite disappointing, because the Report's explicit objective is not to understand the economic reasons for the crash but to study "market mechanisms," to locate a cause for the rapid rate of the market decline, and correspondingly propose improvements to those mechanisms. Since I find it hard to understand how institutions can be sensibly reformed to "prevent" another October 19 without identifying the fundamental economic cause(s) of the crash, I found Dave's public choice perspective on the Report particularly insightful. It offers a plausible explanation for an otherwise ill-defined endeavor. My comment consists of relatively minor criticisms of points Dave makes in his analysis of two of the political explanations of the Report: the public interest and special interest group perspectives. I then question more generally the third explanation Dave offers, the rent extraction thesis, which I do not find persuasive.

(1) *Public Interest Perspective.* In order to point out the difficulty in viewing the Report as furthering the public interest, Dave takes specific problems identified by the Brady Report and suggests private, market solutions with greater welfare-enhancing qualities than the regulatory solutions advanced by the Report. In one instance, however, Dave's market-oriented alternative does not mesh with the Report's proposal. This is the proposal of uniform margin requirements, directed at raising the margin requirements on futures and options, which are set by the exchanges and are lower than the margin requirements for stock, which are set by the Fed. Dave suggests that, rather than have a government agency set margin levels at a

† Professor of Law, Yale Law School and Yale School of Organization and Management.

uniform rate for all exchanges, firms issuing securities should be required to approve the cross-listing of those securities on other exchanges, and their ability to delist should be expanded. The rationale for this change is that firms are expected to desire stricter margin requirements than self-interested market professionals, who are viewed as the advocates of low futures margins. The idea is that, because firms have the proper incentives to choose the optimal margin rate for their securities, their choice of exchange will depend on its margin level, thereby making competing exchanges adjust their margins upward.

I do not understand why a move to firm approval on cross-listing is relevant to the objective of the Report's proposal. The margin requirements that it seeks to unify are the lower levels that apply to index options and futures, derivative securities. These securities are not issued by the corporations whose stocks comprise the underlying index. I therefore do not see how firms can affect the setting of margin requirements on the CME or CBOE by a cross-listing approval rule. Is the proposal that firms must approve the writing by third parties of options on their securities, or more particularly, options on indexes in which their securities happen to be included? Or that firms must agree to the inclusion of their securities in an index, in case that index will be the object of a futures or option contract? If that is what Dave is driving at, the proposal does not seem to me to be sensible. The incentives of firms need not be optimizing in this case because the security of interest to issuers is not the one being traded. Of course, to the extent that an active derivative market increases the value of the underlying securities because investors desire the liquidity and hedging capacity it provides, it is possible that firms' interests will not differ from that of the market-professionals who want low margin requirements. This outcome would presumably be satisfactory to—if not anticipated by—Dave, but not to the Brady Task Force.

(2) *Special Interest Perspective.* Dave maintains that illogic and complexity are prerequisites for a special interest group's legislative success. While these may be sufficient conditions for such legislation, neither condition, in my opinion, is as necessary as his discussion suggests. We can easily locate examples of special interest legislation that are not particularly complex and abstruse, such as rivers and harbors bills, agricultural price supports, or the failure to close a military base. There is nothing that complex in these examples, just the standard Mancur Olson condition of concentrated benefits and diffuse costs. In addition, recourse to illogical reasoning is unlikely always to be the key to success in the securities/financial markets context, because there can be concentrated

interests on both sides of regulatory issues. The interests of groups with equal degrees of expertise and knowledge may conflict—the interests of institutional investors and investment banks, as well as issuers, may conflict with those of other market professionals, such as specialists and market makers. Correspondingly, illogical and complex arguments or proposals will not necessarily thwart opposition to a proposal in this context.

Along this line, the Brady Report may not further the interest of the industry as a whole as Dave suggests, but rather, the interest of one particular sub-group. At least one of the Report's proposals, the unification of margin requirements, is consistent with such a scenario. Dave's explanation, that the uniform margin requirement eliminates nonprice competition, and thus presumably is desired by all industry members for increasing their profit margins, is intriguing—I had not thought of it and I find it a very interesting thesis. But I hesitate to endorse it in toto. The impact of such a change in the securities context is quite different from the airline industry, which Dave provides as an illustrative analogy. Namely, elimination of the lower margin for futures will not accrue to the benefit of all securities professionals, by lowering everyone's cost of operations or raising everyone's profit margin. It will instead transfer wealth from one sector, options and commodities exchanges, to another, the stock exchange, for it reduces the demand for the formers' product. There is also a regionalism issue here, as the sectors have different geographical bases, so the uniform margin requirement shifts wealth from Chicago to New York.

If we examine the crash studies of interest groups and government organizations, the New York-filtered explanation of the proposal is confirmed: The NYSE study, as well as the study by its regulatory authority, the SEC, endorse changing the futures margin requirement in tandem with requiring physical rather than cash settlements—a proposal flagrant in its effort to eliminate competition.¹ But the CME study explicitly opposed a margin rule change.² Moreover, the traders who engaged in heavy futures selling on October 19 were pension funds, trusts and other institutions that do not op-

¹ N. KATZENBACH, AN OVERVIEW OF PROGRAM TRADING AND ITS IMPACT ON CURRENT MARKET PRACTICES (1987) (A Study Commissioned by the New York Stock Exchange), SECURITIES AND EXCHANGE COMMISSION, DIVISION OF MARKET REGULATION REPORT, THE OCTOBER 1987 MARKET BREAK (1988). The NYSE is quite sensitive to its loss of market share in trading volume to Chicago with the advent of the S&P 500 futures contract: another proposal in the study, also supported in the SEC's study, is to create a real security stock index to be traded at a specialist's post.

² PRELIMINARY REPORT OF THE COMMITTEE OF INQUIRY APPOINTED BY THE CHICAGO MERCANTILE EXCHANGE TO EXAMINE THE EVENTS SURROUNDING OCTOBER 19, 1987 (1987) (Committee members: M. Miller, J. Hawke, Jr., B. Malkiel, M. Scholes).

erate with leverage, so a higher margin requirement would not have constrained their actions (and thus not slowed the price collapse),³ although it will decrease the profitability of the futures exchanges. It is not surprising that the Brady Report offers a proposal that leans heavily for one sector of the securities industry; as a New York investment banker, Brady's priorities and sympathies would quite naturally lie with the New York Stock Exchange rather than with Chicago.

I think we can understand other proposals in the Report in this manner as well. For instance, the proposal for a single top coordinator-agency is New York rather than Chicago-oriented. No one ever suggests letting the CFTC run the show (as it has a smaller jurisdiction over financial instruments), and it seems safe to infer that any proposal to centralize, indeed any proposal to unify differences across exchanges, is a way to limit or cut back the commodities exchanges' authority. As the commodities exchanges' differences with the stock exchange have led to successful competition through product innovation, the elimination of that authority is likely to reduce their competitiveness vis a vis the stock exchanges. The NYSE Report's endorsement of having one agency run the show is further supporting evidence of this explanation.

It is true that if the Brady Report had chosen the SEC rather than the Fed as the lead agency, then the case for the Report's favoring New York over Chicago would be more compelling. But such an arrangement would also have been unseemly: a recommendation putting the SEC in charge could have the appearance of egregious bias, which would throw into question the "neutrality" of the entire Report. This could well be an instance of deference to the maxim that "you can be a pig but not a hog."

The explanation involving conflicting interests among exchanges that I have outlined is highly schematic. And for some of Brady's proposals, a geographical-based schism may not exist, such as the call for improved information systems.⁴ Indeed, this proposal can clearly be given an industry group/market professional interpretation: the information called for by the Report involves past trade data, which, as Dave discusses, lends itself to policing insider

³ F. EDWARDS, POLICIES TO CURB STOCK MARKET VOLATILITY 9 (Columbia Business School Center for the Study of Futures Markets, Working Paper No. 176) (1988).

⁴ This is one proposal that the CFTC study supported. FINAL REPORT ON STOCK INDEX FUTURES AND CASH MARKET ACTIVITY DURING OCTOBER 1987 TO THE U.S. COMMODITY FUTURES TRADING COMMISSION, DIVISIONS OF ECONOMIC ANALYSIS AND OF TRADING AND MARKETS (1988) [hereinafter CFTC FINAL REPORT]. The data on individual trades collected by the CFTC from the CBOE and CME is more specific than that collected by the NYSE, and hence the CFTC partly saw this proposal as aimed more to exchanges regulated by the SEC than those in its jurisdiction.

trading, of particular benefit to this interest group. The information called for by economic theory to reduce the likelihood of another stock price collapse from dynamic hedging strategies, which is the ostensible goal of the Report, involves, however, information on *future* trading, such as the number of stop loss and other limited trade orders (the future trading plans of informationless trading of program traders).⁵ I offer the New York gloss on the Report, then, as a means of overcoming the failure Dave finds in the special interest group perspective largely because of apparently ambiguous features like the Fed proposal and the industry-wide perspective he adopts.

(3) *Rent Extraction Perspective.* Dave's principal support for the rent-extraction perspective is the failure of Congress to enact the Brady Report's recommendations. There is, however, an easier, more obvious, explanation for Congress's failure to implement the Report. The Reagan Administration, and the Chairman of the Fed in particular, opposed it. It is unlikely that Congress can get very far with such a plan without White House support. There are typically numerous items on the active policy agenda, and unless a proposal has intense or broad support, Congress will move on to another item that can be more consensually resolved.

A similar set of circumstances has arisen regarding the regulation of takeovers, an area with which I am more familiar than stock market regulation. The demand for additional federal legislation to restrict hostile takeovers has been extraordinarily intense, with over 100 bills introduced over the past four years, not to mention numerous hearings and Congressional reports, on the subject.⁶ The public has little interest in, or knowledge about takeovers (and hence about their beneficial effects), the business community strongly supports increased restrictions, and the individuals who are harmed by takeover legislation are not politically organized although there are specific groups who suffer (shareholders and bidders).⁷ It would appear to be a perfect situation for Congressional action. Yet no major legislation has been forthcoming. In the takeover context, as with the Brady Report, the Reagan Administration opposed increasing regulation (as did the relevant agency head, SEC Chairman Shad). This may not simply be a function of the Administration's free-market ideology. As I have suggested in the takeover legislation context, there are institutional features, identified by political scientists, that make the President more removed from pork-barrel

⁵ Grossman, *An Analysis of the Implications for Stock and Futures Price Volatility of Program Trading and Dynamic Hedging Strategies*, 61 J. BUS. 275 (1988).

⁶ Romano, *The Future of Hostile Takeovers: Legislation and Public Opinion*, 57 U. CIN. L. REV. 457 (1988).

⁷ *Id.*

politics. In particular, the President is elected by, and represents all citizens, unlike members of Congress whose election is regionally based.⁸

There are at least two other simple reasons for inaction that cut against a rent-extraction hypothesis. First, the geographically differential impact of the Report's proposals that I have already noted, provides a major source of congressional inertia. The New York-Chicago split suggests that Congress would similarly be divided in its support for the Report, which makes enactment unlikely. This can be observed in the internal jurisdictional conflict between the agricultural committees that have oversight of the commodities exchanges and the financial and banking committees whose oversight responsibilities include the stock exchanges.

Second, there have been voluntary reforms initiated by the private parties and the Administration which undercut the need for Congress to act—perhaps these substitute for the payments to legislators that Dave has in mind. Examples are the trading price limits adopted first temporarily and later permanently by the CME and CBOE under the CFTC's supervision,⁹ coordinated trading halts for all domestic markets approved by the SEC and CFTC,¹⁰ both of which implement the Brady Report's advocacy of "circuit breakers," and acceleration of plans for increasing computer facilities by the NYSE and NASDAQ. In addition, the Reagan Administration convened an interagency group of the Fed, the SEC, and the CFTC, to coordinate the approach to the issues and problems identified by the Report across the various markets. The adoption of these alternatives to the Brady proposals makes the case for enactment less immediate as their proponents can maintain that time is necessary to determine the alternatives' effectiveness.

These simpler and more straight-forward explanations for Congressional inaction seem so persuasive to me, and not to Dave, perhaps because I find, *a priori*, a rent-extraction story of legislation unsatisfying. To begin with, I do not understand why the threat of unpopular legislation would be credible. I suppose one problem is that my premise is that legislators are motivated by reelection, which requires rents to flow to constituents. It would seem unlikely that legislators who extract rents from constituents will be reelected. If the hypothesis then is that legislators extract rents from groups that are not in their districts, it is even more unlikely that the legislator will be able to enact the threatening legislation: the organization of

⁸ *Id.* at 489.

⁹ CFTC FINAL REPORT, *supra* note 4 (limits made permanent in January 1988).

¹⁰ SEC, CFTC Approve Coordinated Trading Halts in Volatile Markets, [July-Dec.] Sec. Reg. & L. Rep. (BNA) No. 41, at 1580 (Oct. 21, 1988).

Congress provides committees with the critical power over the production of legislation within their jurisdictional domain, and committee assignments follow a self-selective process matching members with their constituents' interests.¹¹

Many additional questions can be raised concerning the credibility of the threat: How are the coalitions for enactment guaranteed? What guarantees the President's assent? What about the relevant agencies and their positions, must they share in the rents as well? Why doesn't the interest group that is threatened respond by handsomely funding the election campaigns of challengers who promise not to engage in the practice of extraction? Are there any instances of laws enacted because the rent went unpaid, thereby making the threat credible, in the securities setting or any other context?

Is the answer that in equilibrium no such laws will be passed because the rent will always be paid to avoid extraction? (This assumes the credibility of the threat without any empirical support.) And does the answer further go that if challengers are elected, to succeed in Congress they must consent to the extraction? Without a formal model, it is impossible to know whether or not there are multiple equilibria, an equilibrium in which there are credible threats and rents are extracted as Dave asserts, but also an equilibrium in which threats cannot be credibly made and there are no extractions.

Moreover, if the rent extraction equilibrium is unique, then the hypothesis seems even more irrefutable than Dave claims that the interest group explanation is, for we never will see an example of a threat carried out to evidence the credibility of threats. Further, how can we ever identify a rent payment—if we find a PAC contribution by the NYSE to banking committee chairs, what does that demonstrate? It could be a rent extracted to not pass legislation, or a payment hoping that favorable legislation will be put on the agenda or passed, or a payment for some piece of legislation previously passed, or payment to gain access in order to counteract the influence over the legislator of a competing interest group, which is aided by regulation. In sum, a contribution could be retrospective or prospective, and there is no way to distinguish empirically between the possibilities. Under the New York gloss of the Report, the symbolic act of Congress giving serious consideration to its proposals may be worth a NYSE contribution, because it may lead to voluntary action by the futures exchanges and CFTC to compromise

¹¹ Rohde & Shepsle, *Democratic Committee Assignments in the House of Representatives: Strategic Aspects of a Social Choice Process*, 67 AM. POL. SCI. REV. 889 (1973); Weingast & Marshall, *The Industrial Organization of Congress: or, Why Legislatures, Like Firms, Are Not Organized in Markets*, 96 J. POL. ECON. 132 (1988).

with the SEC out of concern over regulation and thereby limit competition in the NYSE's favor. Of course, this is a different rent-extraction story, of the special interest group sort: the payments go to competing interest groups, not solely to legislators.

When there are alternative explanations of a phenomenon that are equally difficult to test, then, in my view, the decision rule for choosing between them should be to invoke Occam's Razor. The interest group story is without question the cleaner explanation. But I also do not think that the interest group story is as untestable a theory as does Dave. We can, at least in some cases, try to measure *ex post* the wealth effects of particular pieces of legislation on different groups. For instance, we can look at changes in product prices, in costs where available, in market concentration, and where the beneficiaries are publicly traded firms, in stock prices, as well as examine the express actions and reactions of the members of the affected industry. If an effect cannot be identified, while that might lead a researcher to try to find another interest group, which leads to Dave's irrefutability charge, it might also lead the researcher to reject the hypothesis.

Dave has provided us with a provocative account of the Brady Report. I would urge him to voice even greater confidence in one of the explanations he proffers, the interest group perspective. He persuaded at least this reader.