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DISCUSSION

F. R. EDWARDS*: In reviewing a broad array of regulatory issues Professor Houthakker has presented us with a number of provocative conclusions and judgements. Rather than attempting to fit his analyses of these issues into any single conceptual framework that ties together the many diverse aspects of futures markets regulation,[1] he provides us with an analysis of each issue and his concluding views as to the wisdom of certain kinds of regulation. In some instances he concludes by suggesting a need for further research (the solvency of Clearing Houses), while in others he ends with concrete and specific recommendations (position limits).

As an early student of futures markets and an esteemed economist who has followed these markets closely for many years. Professor Houthakker's views deserve considerable attention. Overall, I am in agreement with many of his conclusions. My comments, therefore, stem more from what I believe are sins of omissions or overstatement. It is not so much that what he says is wrong, but what he fails to say that requires comment.

Professor Houthakker begins with a paradox which he fails to resolve to my satisfaction. He says: "With hundreds of traders actively participating in the determination of futures markets prices—the very epitome of perfect competi-

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[1] In a recent paper I attempted to provide such a framework. See "The Regulation of Futures Markets: A Conceptual Framework," *Journal of Futures Markets*, Winter, 1981.

tion—how is it that we need so much regulation to prevent the monopolization of these markets [or corners and squeezes]?" His answer: "Perfect competition is not self-sustaining: if left to themselves traders ... would ... form coalitions with a view to exercising market power."

Taken to a *reductio absurdum*, however, this explanation implies that all highly competitive markets should be regulated. The economist's traditional view is just the opposite: that only highly monopolistic (or natural monopolies) should be candidates for regulation. Certainly one of the virtues of markets with many sellers is the exceedingly high costs associated with the formation of effecive and lasting cartels. It is, indeed, in just such markets that competition can be expected to be self-sustaining. If not in these markets, then in which?

A more satisfactory resolution of Professor Houthakker's paradox would be to argue that futures markets are unlike other markets in important ways that make them more susceptible to manipulation and monopolization.[2] Specific delivery dates, standardized contract specifications, restricted delivery options, and high leverage may be such distinct characteristics. This has clearly been the viewpoint of legislators throughout the history of futures markets regulation. To date, however, there does not exist a widely accepted analytical argument to support the notion that futures markets are especially susceptible to monopolization.

Alternatively, one might argue that the social functions performed by futures markets—price discovery and risk allocation—are so important that even occasional departures from the competitive norm would impose heavy costs on society. While important, however, these functions do not seem significantly more critical than those performed by many other markets, where we have been and are quite content to live without an elaborate regulatory apparatus to prevent monopolization. Clearly, there is more to be said about Professor Houthakker's paradox.

Similarly, his assertion that "... self-regulation by exchanges cannot be the complete answer, no matter how competitive the activity on their trading floors ... " leaves much unsaid. At bottom, this assertion must be supported by showing that those doing the self-regulating do not have among their primary objectives the furtherence of the public good, but rather have goals that are inconsistent with, or are at odds with, the protection of customers and the development of efficient markets. But Professor Houthakker does not tell us how the governance structure and the managerial workings of futures exchanges fail us. Indeed, these aspects of futures markets are poorly understood even today. With many diverse interests represented on the governing bodies of exchanges, it is not at all clear just when self-regulation is or is not a reasonable and viable solution.

Nor do the occasional and highly popularized corners that have occurred in the past provide very convincing evidence that existing self-regulation is inadequate. A notable omission from scholarly work on futures markets are careful historical studies of exactly what happenned during these episodes of "exchange breakdown." To what extent was inadequate self-regulation an important contributing factor? Professor Houthakker, of course, may be right—that self-regulation alone is inadequate—but it would be comforting to understand better why he might be right.

[2] *op. cit.*

Turning to somewhat more specific issues, Professor Houthakker's discussion of position limits does not include consideration of the possibility and wisdom of requiring fuller public disclosure of positions, or of the distribution of open interest as maturity approaches. Exchanges have not customarily disclosed this information to traders, although some regulators have proposed just such disclosure as a remedy to corners and squeezes.[3]

With respect to the solvency of Clearing Houses, I agree that we have a very vague understanding of what the important issues are and of the benefits and costs associated with alternative types of solvency regulations. I would go further than Professor Houthakker does, however, and argue that price limits should probably be eliminated, even if this were to necessitate higher variation margins. Clearing Houses are obviously an important institution and should be given additional thought and scrutiny.

An issue about which he and I are in greater disagreement is the regulation of off-exchange contracts. At times he seems to be saying that there should be regulation of off-exchange instruments only where there has been fraud, and no regulation "where no allegation of fraud could be made." Needless to say, I do not see his logic here. In my view both exchange and off-exchange instruments which are in some meaningful sense substitutes for one another should be subject to identical regulation. Can it be otherwise and have both co-exist for long? Whether off-exchange instruments should be more regulated than at present or exchange instruments less regulated than at present is a separate issue. Whatever the right dose of regulation, it should be administerd to both equally.

Finally, I am dubious about (or at least perplexed by) Professor Houthakker's synthesizing statement about the difference between financial futures contracts and other futures contracts. He says: "There is really only one difference and it is merely a difference of degree: financial futures are more important from a policy point of view." This view seems to be predicated upon a belief that financial futures are somehow related to the successful implementation of monetary and fiscal policy. I am unaware of either acceptable economic theories or empirical evidence to support this view. Once again, Professor Houthakker may be right, but I do not think he has provided us with an explicit enough analytical foundation to permit an evaluation of his conclusion.

It should not have to be said, in closing that Professor Houthakker has consciously attempted to stimulate our thinking about a number of important issues in futures markets regulation. While I have been critical of some of his conclusions, it is more often true than not that in economics a critical ingredient in our learning process is to have someone fearless enough to make a strong assertion to which others can respond. Professor Houthakker has performed this role admirably.

[3] See, for example, Commissioner James Stone, "Additional Comments on the Interagency Study of Silver Markets," CFTC, June 1981, p. 45.

DISCUSSION

S. SMIDT*: One important development in economic theory in recent years has been the effort to deal with agency problems. If successful, this will enlarge the

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