

Futures Markets in Transition: The Uneasy Balance Between Government and Self-Regulation

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“**T**here is considerable controversy today in the United States over whether additional government regulation is needed to assure the safe and efficient operation of futures markets. While these markets have been operating with relatively little government supervision for more than a century, dramatic changes have occurred in the last ten years that increase the scope and importance of these markets.

First, futures markets have increased in size during the last ten years by more than they did in the entire previous hundred years of their existence. Second, new futures contracts have been developed with new uses and new participants. The reach of futures markets has expanded to all major sectors of the economy, and events in these markets are felt widely throughout the economy.

Third, as the size and scope of futures markets have increased so has the fear of a cataclysmic event that could bring them crashing down. With larger and more active markets it has become possible for traders to hold bigger positions; a default by such a trader, it is feared, could topple the whole industry, and with it major financial institutions. The recent “Silver Crisis” remains a vivid reminder of the close links between futures markets and other financial markets and institutions.

Finally, the newly traded stock index futures promise to change significantly the nature of futures markets, perhaps bringing millions of new participants into these markets. More Americans are familiar with buying and selling stock than with any other financial instrument. Options also provide an investment instrument with a limited downside loss potential—the premium—but with an unlimited potential for gain, a combination that may prove to be highly attractive to the many small, unsophisticated investors who persistently dream of crossing the rainbow into the World of Oz. Thus, the potential for abuse by the unscrupulous salesman or broker may increase.

Many public policy issues are presently under debate. Two are discussed in this article: federal fixing of margins on futures contracts, and the need for additional investor protections. These issues amply illustrate the fundamental tensions that

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exist between government and self-regulation. In addition, they lay bare the fundamental arguments that underlie the debate about what the role of government regulation should be in futures markets. Before turning to an evaluation of these issues, however, some discussion of the present roles of government and self-regulation in futures markets is necessary in order to provide the requisite institutional backdrop.

I. SELF-REGULATION IN FUTURES MARKETS

Self-regulation by business is as old as commerce itself. In its usual form it is used by members of an industry to set standards, either with respect to the quality of the product or the standards of conduct among the members of the industry. In financial industries, this has usually meant solvency standards (such as minimum capital requirements) and ethical standards (such as fiduciary and conflict-of-interest codes). Its goal is to enhance the value of the product to consumers, to lower the transaction and information costs associated with it, and to increase the demand for the product; as a consequence, to increase industry profits in the long run.

Self-regulation is not without its critics. To some observers self-regulatory organizations look more like industry conspiracies or cartels to curb competition than like benefactors of the public interest. They exist, it is argued, to increase industry profits by restraining competition, and not by increasing the value of the product to consumers. In most cases the truth lies somewhere in between. Self-regulation often does diminish competition to some degree, but may still have benefits that outweigh this social cost. In evaluating this tradeoff, a primary factor is: "How critical is self-regulation to the economic purpose of the industry?" Once it is judged to be of critical importance, "Are the specific rules and regulations that are imposed necessary to achieve the desired ends, and are they the least restrictive ones possible consistent with achieving these ends?"

In futures markets, self regulation is vital: The markets would not exist without it. Organized futures markets are the creations of joint ventures among many individuals and institutions which have as one of their major purposes the imposition of common rules and regulations on the markets and their participants. Although contracts and agreements about future events could exist without such regulation, organized futures markets could not. Forward contracts are contracts about future events, but they are not future contracts.

What, then, distinguishes futures contracts on organized futures exchanges from other contractual arrangements about future events? There is, I believe, one essential distinction: liquidity. Futures contracts are bilateral contracts concerning future events that are transformed into highly liquid financial instruments through the imposition of an elaborate self-regulatory structure. Through this structure a highly standardized product (or a futures contract) is created that permits individuals and institutions to eliminate or transfer risk while at the same time not exposing themselves to the credit risk that is often associated with bilateral forward contracts. A key purpose of self-regulation is to reduce the transaction and information costs associated with contracting about future events to a level that optimizes the risk-shifting and price-discovery functions of futures markets.

Two self-regulatory institutions are central to futures markets. One is made up of the organized futures exchanges, which determine the terms of futures contracts; provide a forum (or market) for buying and selling futures contracts; lay down, en-

force, and monitor the rules which govern the buying and selling of futures contracts; and impose conditions on the professionals who trade futures contracts (exchange members) to assure fair, orderly, and efficient markets.

The second institution (which may or may not be part of the same corporate organization that defines the exchange) is made up of clearing associations. Clearing associations are probably not as well understood as exchanges. Their very name is somewhat misleading. While, as would be expected, they do perform a "clearing" role, much as do clearing organizations in banking and securities markets, they do much more: they act as guarantors and as regulators to important participants in futures markets.

In particular, all futures trades on organized exchanges must be cleared through clearing member brokers, or through Futures Commission Merchants (FCMs), to whom the clearing association is a guarantor and regulator. If an FCM is unable to meet its financial obligations to its futures customers, the clearing association may meet those obligations, either in full or part depending on the circumstances.

Clearing associations also impose various regulations on their members. To begin with, membership is restricted to those who can meet certain financial and character standards, such as minimum capital requirements. In addition, minimum initial margins are imposed on all clearing members. Mark-to-the-market accounting is required, and daily margin settlements strictly enforced. Position limits are sometimes imposed, and in many cases members must make contributions to guarantee funds. These regulations are directed at maintaining the integrity of clearing associations and at keeping member FCMs (and the industry in general) sound.

These two self-regulatory institutions—exchanges and clearing associations—are fundamental to the success of futures markets. Both are also joint ventures among many participants who are inextricably linked together in action and conduct. Misconduct on the part of one member can have serious repercussions for all others. A member who squeezes, corners, or manipulates the market, or becomes insolvent, throws a deep shadow of suspicion over the entire venture; such behavior can undermine public confidence to the detriment of all. It is the function of self-regulation to keep these things from happening, and, in other ways, to provide safe, efficient, and fair futures markets. Without these attributes, public participation in these markets would wither away.

II. WHAT IS THE ROLE OF GOVERNMENT REGULATION?

Every few years instances arise that invoke renewed charges that self-regulation has failed to prevent market manipulation and excessive speculation. Since the mid-1970s manipulation charges have been leveled at contract markets for potatoes, wheat, soybeans, heating oil, and, of course, silver. In addition, the newly introduced stock index futures and options have raised again the ageless charge that futures markets are little more than gambling casinos where professional speculators can take advantage of the unskilled and unsophisticated. These concerns—that futures markets are subject to speculative excesses and are highly susceptible to unfair market manipulations—lay at the heart of government intervention into these markets.¹

¹See Edwards, F. (1981): "The Regulation of Futures Markets: A Conceptual Framework," *The Journal of Futures Markets*, Supplement to Vol. 1: 417-440, 418.

Given the general success that self-regulation has had in futures markets, however, it may be useful to try to be more precise about when government regulation is needed. Are there areas of regulation where the industry's collective interests deviate significantly from the public interest? Or, in somewhat more stilted language, do the industry's self-regulatory institutions fail to "internalize" some of the "externalities" associated with futures markets? If history can be taken as a guide, it is clear that legislators and regulators in the United States believe that self-regulation does fail to internalize fully all externalities. Innumerable government manhours, for example, are spent trying to determine whether the new futures contracts proposed by exchanges will have real and substantial economic benefits, as opposed to being merely speculative vehicles. Their concern, presumably, is that speculative activity in such cases does not employ economic resources in a socially productive way.

In addition, as with all self-regulation, there exists the potential for conflicts of interest. In the futures industry, as in other self-regulated industries, the regulators themselves are heavy users of the market, and at times their interest may clash with those of other users. The order by COMEX in January 1980, at the height of the "Silver Bubble," to trade "for liquidation only," is often cited as such a case.² Is there a role for government regulation in curbing potential conflicts-of-interest abuses?

Another role of government regulation is in governing and monitoring "unregulated" participants in futures markets: those who are not members of either futures exchanges or clearing associations. In particular, nonmember FCMs, commodity pool operators, and trading advisors are subject to government regulation rather than industry supervision. The recent formation of the industry's new self-regulatory body, the National Futures Association (NFA), however, is directed at eliminating part of this gap.

Just why such gaps in the coverage of self-regulation should arise is unclear. It may simply be another case of "regulatory lag," where the industry does not quickly perceive that the unregulated segment of the industry is of growing importance. Also, political and economic differences within the industry may prevent it from expanding the scope of self-regulation, perhaps due to the additional costs involved; or the gap may simply reflect a difference of opinion as to the importance of the unregulated individuals and institutions. The full explanation most likely encompasses all of these factors.

Finally, *government has a role to play in assuring that the rules and regulations established by self-regulatory bodies do not unnecessarily restrict competition.* In particular, the rules and regulations of such bodies should not restrict competition beyond what is necessary to accomplish their purpose. In the United States responsibility for maintaining the appropriate degree of competition in the futures industry rests with the Department of Justice and our antitrust laws, and with the CFTC.

In summary, a taxonomy for explaining why government supervision might supplement self-regulation in futures markets is the following: the failure of self-regulatory institutions to internalize important externalities; the fear of regulatory mismanagement due to conflicts of interest; the failure of self-regulation to extend

²CFTC Report to Congress in response to section 21 of the CFTC Act, Pub. L. No. 96-276, 96th Congr. 2nd Sess., 5, 7, 94 Stat. 542 (June 1, 1980), p. 124.

to significant segments of the industry; and, the fear that self-regulation may be overly restrictive and unnecessarily anticompetitive.

TWO CASE STUDIES: FEDERAL MARGIN SETTING AND INVESTOR PROTECTION

To illustrate the tensions that presently exist in futures markets between government and self-regulation I shall discuss two regulatory issues: federal setting of margins on futures contracts and investor protection safeguards. Together, these encompass the fundamental issues and fears that lie behind calls for greater government regulation of futures markets.

A. Government Margin Setting

Proponents of giving the federal government (either the CFTC or the Federal Reserve) authority to set minimum margin requirements on futures contracts have several objectives in mind. The first is to control (or reduce) the amount of credit used to support futures market transactions. The presumption is that credit could be employed more productively elsewhere.³ The second is to dampen "speculative excesses," so that futures prices reflect more accurately the underlying economic conditions (or are more efficient). For example, if unwarranted speculative activity were to threaten to increase futures prices excessively, margins presumably would be raised to keep this from happening, and vice versa. In addition, excessive speculation may be fueled by the pyramiding of futures positions by winners during market swings, which could ultimately result in widespread margin calls during a market reversal. The fear, obviously, is that the result will be a financial panic precipitated by the collapse of a speculative bubble. Proponents argue that the government may be able to prevent this by timely changes in margins.

Controversy over whether federal regulatory authorities should have the power to set (or at least review) futures margins goes back to the early 1930s, when Congress was rewriting our securities regulations in the aftermath of the Great Depression.⁴ Although Congress did not see fit to grant such authority then, more than a dozen proposals have been submitted since then to give margin-setting authority to one or another federal regulatory agency.⁵ Each time, however, it has left margin authority in the private sector, with futures exchanges and clearing associations; and, in sections 5(a)(12) and 8(a)(7) of the Commodity Exchange Act, Congress expressly precludes the CFTC from exercising such authority.

The introduction of stock index futures has rekindled this controversy. On March 3, 1982, the Federal Reserve, pursuant to its presumed authority under the Securities Exchange Act of 1934, issued an "advance notice of rulemaking," ask-

³See, for example, Commissioner James Stone's statement to the Subcommittee on Conservation, Credit, and Rural Development of the Committee on Agriculture, U.S. House of Representatives, Washington, DC, February 28, 1982, p. 17.

⁴See, for example, *Public Papers and Addresses of President Roosevelt*, Random House, New York, 1938, Vol. 3, Document 52, p. 170.

⁵Stone, *op. cit.*, pp. 3-4; and *Margin Requirements for Transactions in Financial Instruments*, Hearing Before the Senate Committee on Banking, Housing, and Urban Affairs on S. 2704, 96th Congr., 2nd Sess. (May 29-30, 1980), pp. 214-218.

ing for comments on the possibility of its establishing margin requirements for futures contracts based on stock indexes. And in an earlier (February 17, 1982) letter from Federal Reserve Chairman Paul Volcker to CFTC Chairman Philip Johnson, the Federal Reserve stated that it already had margin-setting authority over stock index futures, and that it might be necessary to use it, "not only to limit use of credit for speculative purposes, but also to assure competitive equality among functionally similar instruments" (meaning common stock).

The Federal Reserve has been prodded by influential legislators. Even earlier, on February 5, 1982, Congressman John Dingell (Chairman of the House Committee on Energy and Commerce) and Congressman Benjamin Rosenthal (Chairman of House Commerce, Consumer, and Monetary Affairs Subcommittee) wrote separate letters to Paul Volcker urging him to direct the Federal Reserve to impose margins on stock index futures.

Chairman John Dingell declared:

From any standpoint, the risks to investor protection and market stability, as well as the safety and soundness of the brokerage community, posed by this highly-leveraged KCBT (Kansas City Board of Trade) stock index futures instrument would be greatly compounded were you not to exercise your margin authority. The Congress conferred margin authority upon the Federal Reserve Board to both further macroeconomic ends and to protect investors from excessive risks incurred by trading upon little or no margin. Those of us who recall what the mighty forces of speculative fever, fed by fantasies of instant wealth, did to the market of the '20s and the scar it left on Wall Street, have no desire to witness a recurrence of any kind in these newly-developed markets.

Chairman Benjamin Rosenthal added his support by quoting approvingly CFTC Commissioner James Stone's statement in "Additional Comments on the Inter-agency Study of Silver Markets" (June 1981):

"The exchange governing boards are well equipped to adjust margin levels in order to protect the solvency of their members. They are not constituted to take account of broader economic issues in their decision-making. As long as customer margins are set by the exchanges, it is predictable that they will be held at the lowest possible level which affords the necessary measure of safety against non-performance on futures contracts. There is no reason to believe that this is the same margin level which would best promote efficiency of pricing or maintain a desirable mix of commercial and speculative market use. "Even if one exchange were willing to raise margins in the furtherance of sound economics for the system as a whole, competitive pressure would force it to retreat. The dynamics of this pressure are such that margins would probably be kept low even if every individual exchange felt that higher margins would serve a useful policy end. The government need not be involved in day-to-day fine tuning of margin levels. Government should have a place in the establishment of a protective floor. It took the 1929 stock market crash to educate the public about the hazards of insufficient stock market margins. I hope it will not require a genuine crisis to educate people that there is a public interest, as well as a private one, in the setting of futures margins." [at p. 41, report, p. 125]

Chairman Rosenthal then added his own words:

Margins for securities and commodity futures have usually been treated separately and distinctly. However, the public policies on credit allocation, capital investment, volatile speculation, or inflationary momentum should outweigh history or form, and margin regulation on stock index futures should be set by the same agency and in pursuit of the same public objectives as margin regulation of equity and debt securities.

Thus, government authority to set margins on futures is very much a live issue, and as the market for equity-related futures expands so will the controversy over this issue.

1. Margins and Speculative Activity

Using government to "fine-tune" speculative activity by making continuous adjustments in minimum margin requirements is neither realistic nor an idea espoused by even proponents of government margin setting. Under most market conditions it is impossible to determine whether there exists "excessive" speculative activity or whether speculation is destabilizing. There is not even a useful definition and measure of excessive speculation. Also, neither theory nor what empirical evidence we have can support the notion that in general speculation increases rather than decreases price volatility in futures markets.

It is equally clear, however, that under some market conditions speculative activity can be a destabilizing force. One may not know either how to measure it or how to define it, but may still be able to recognize it at certain times as a destructive force. Thus, there is really only one cogent argument for giving government margin authority to control speculative activity, and that is if it can prevent the kind of panic or speculative bubble that sometimes arises because of excessive and irrational speculation.

Such a bubble might arise as follows. Futures prices on some commodity begin to rise because of heavy purchases. The initial increase in demand may be the result of pure speculative activity, but need not be. It may be due to a significant change in some real economic factor, or it may be due to an attempt to corner the market in that commodity. Alternatively, it may be caused by a few large buyers who, while well-intentioned, are nonetheless captives of some irrational theory.⁶ However it starts, prices begin to rise, and rapidly.

At first speculators will be uncertain about why prices are rising, but will nevertheless see opportunities for profit by joining the buyers. They may, for example, convince themselves, on the basis of imperfect information, that the new equilibrium price will indeed be much higher; or they may simply trust their ability to sell before everyone else does, and before the market collapses.

In either case, irrational speculative behavior plays a role, and it is no good saying that such behavior does not happen (even though economic theory says it

⁶For example, traders may hold to a view that there is some technical necessity for the prices of certain commodities to have a fixed relationship, so that when the price of one rises they buy the other to maintain that presumed relationship. This is one explanation advanced to explain the behavior of the Hunt Brothers in silver in 1979 and 1980. See, Fay, Stephen (1982). *Beyond Greed*, The Viking Press, New York, Chap. 2.

should not). History is replete with financial panics and bubbles in which irrational speculative behavior was undeniably present.⁷

But do low margins on futures contribute to such an irrational speculative frenzy? Low margins do allow speculators to make greater purchases for a given equity than they could if margins were higher. Further, as futures prices rise, the mark-to-market accounting convention increases the equity of winning speculators, and, in our scenario, transfers wealth from rational to irrational speculators, so that the latter can increase the size of their positions (called pyramiding).

When the inevitable collapse of prices comes, however, the tables are turned: Irrational speculators become subject to widespread margin calls that they cannot meet, their positions are liquidated, and prices come tumbling down with meteor-like velocity. Furthermore, uncovered defaults leave FCMs to make good on these positions, and further attempts by FCMs to liquidate defaulted positions may make matters worse.

Finally, if some major FCMs default, clearing associations become threatened. Clearing associations have relatively small margin funds that are posted by FCMs, and they have even smaller guarantee (or surplus) funds on which to call. Their last-resort alternative is to assess members to cover the losses. But would clearing members, while perhaps obligated to pay such assessments, in fact pay them, especially if it meant their bankruptcy? If a major clearing association were to fail to meet its obligations, the entire futures industry would be shaken to the core. A futures contract would cease to be a futures contract; the need to know with whom you contract would again be paramount. Futures markets would, at least for some time period, cease to exist.

Up to now, this story has concerned only futures markets. However, the bankruptcy of major futures traders, major FCMs, and a major clearing association would surely have severe repercussions throughout the entire economy, and especially in the banking industry. Banks may ultimately be the ones left holding the proverbial bag. Through direct loans to traders and FCMs, and through letter-of-credit guarantees to clearing members, major banks have extended substantial amounts of credit to futures markets participants. If banks cannot collect on those loans, and must make good on their guarantees as well, they too may be threatened. Needless to say, the failure of one or two major banks, with their complex and extensive web of relationships with other financial institutions, could bring down the entire financial system. The reader can write his own ending to this story.

This is clearly a chilling scenario, and also a highly remote one. It is just such fears, nevertheless, that I believe motivate supporters of government margin-setting powers. Their argument is not that speculative excesses cannot occur in the absence of low margins, but that such speculative episodes can be much worse if fueled by low margins.

However, would giving government margin-setting authority make the occurrence of such speculative bubbles either less likely or less severe? There are two possible views of how this authority could be used: Government regulators may impose higher margins at all times, or they may arguably be more reliable and efficient in changing (raising) margins in a timely fashion to prevent the occurrence of speculative bubbles than are exchanges.

⁷See Kindleberger, Charles (1978): *Manias, Panics, and Crashes: A History of Financial Crisis*, Basic Books, New York.

The first of these reduces to a cost-benefit issue. If government insists on higher than "optimal" margins all or most of the time,⁸ in order to guard against the possible occurrence of a speculative bubble, the effect would be to impose higher cost on both the futures industry and society as a whole. Higher margins make futures transactions more costly, reduce the use of futures markets, reduce market liquidity, and increase the cost of hedging and risk-shifting. The result may be a higher cost of risk to society, and, with less market liquidity, possibly poorer price discovery. The ultimate effect may be a poorer allocation of resources throughout the economy, and higher production costs.

Against these costs must be weighed the possible benefits that may flow from reducing the likelihood of a speculative bubble. Needless to say, the expected present value of these benefits does not seem high, since such speculative episodes are quite rare. Furthermore, historical evidence does not suggest that speculative bubbles in futures markets have imposed heavy costs on society.⁹ Therefore, it does not seem reasonable to impose unnecessarily high margins on futures transactions most of the time only for the purpose of preventing a speculative bubble that may never occur, or, if by some chance one did occur, to mitigate the social costs of such a bubble, since such costs are unlikely to be very high.

The second role envisioned for government regulators is to have them change (or raise) margins periodically and in a timely manner to prevent speculative bubbles. While more defensible from a cost-benefit perspective, this view immediately raises the question of why the industry's own self-regulatory mechanism cannot be depended upon to do the same thing. An answer that self-regulators cannot be depended upon to use their margin powers to accomplish the same thing strikes at the very principle of self-regulation.

The recent "Silver Bubble" has again brought this issue to the forefront. While silver prices skyrocketed from less than \$10 to over \$50 an ounce throughout the fall and winter months of 1979 and during the early days of 1980, COMEX's Board of Governors did little to dampen the speculative euphoria until January 21, 1980, when silver had already topped \$50 an ounce. Then they raised margins sharply (and retroactively), and took the dramatic step of ordering that thereafter all silver trading should be for liquidation only. Nearly three months earlier, on October 25, the Chicago Board of Trade virtually closed its silver market by imposing stringent position limits on speculators.

This episode has been cited widely as an illustration of the weakness of self-regulation in dealing with potential crises. Advocates of governmental powers argue that the vastly different interests that are present on the governing boards of exchanges, and the conflicts of interest they pose, paralyze the decision-making of exchanges at just those times when swift decisions are needed; by inference, this would not happen within a government regulatory agency, such as the CFTC.

Largely overlooked, however, is that during the same months that COMEX failed to act, the CFTC also failed to act under its emergency powers: Its four commissioners were evenly divided, two for and two against doing something. In addition, the Chicago Board of Trade did act before both COMEX and the CFTC (which

⁸For a discussion of what constitutes an optimal margin, see Telser, L. (1981): "Margins and Futures Contracts," *The Journal of Futures Markets*, 1(2): 225-254.

⁹For example, there is no evidence to suggest that the recent "Silver Bubble" resulted in significant social costs.

never acted).¹⁰ Thus, it is a somewhat distorted characterization of the silver episode to argue that it shows that government regulators would act in a more timely fashion than would self-regulators.

In any case, if the objective is to permit government to intervene in unstable market situations, such as to prevent the formation of a speculative bubble, it already has authority to do so. Section 8(a) (9) of the Commodity Exchange Act authorizes the CFTC

to direct the contract market whenever it has reason to believe that an emergency exists, to take such action as, in the Commission's judgment, is necessary to maintain or restore orderly trading in, or liquidation of, any futures contract. The term "emergency" as used herein shall mean, in addition to threatened or actual market manipulations and corners, any act of the United States or a foreign government affecting a commodity or any other major market disturbance which prevents the market from accurately reflecting the forces of supply and demand for such commodity.

The CFTC has interpreted this language to give it the authority, among its other powers, to change margin requirements on futures contracts during "emergencies." It also has done so in the past.¹¹ As referred to earlier, it is this power that a divided CFTC could not agree to invoke during the 1980 "Silver Bubble."¹²

Thus, the usefulness of additional government authority to set minimum margins on futures in order to curb speculative excesses is questionable. The CFTC already has such power in the event of a major market disturbance, and the imposition of higher (average) margins during normal (or stable) market conditions would be too costly from a social point of view and would accomplish very little. It may be that self-regulation does not always work to perfection, but then neither does government regulation. On balance, self-regulation still offers the best cost-benefit tradeoff.

2. Margins, Credit Allocation, and "Macroeconomic" Externalities

Another argument used to support government margin-setting authority is that low margins on futures divert credit away from more productive uses, and, in particular, from equity markets where such funds contribute to capital formation and economic growth. Higher margins on futures, it is argued, will reduce the amount of credit used to support futures transactions and therefore increase credit availability elsewhere.

But this is incorrect. Unlike the purchase of equity, the purchase of a futures contract does not require the buyer to pay the seller anything at the time of purchase; he need only tender a security deposit with his broker. There is no borrowing to pay the seller, and no credit extended to support the purchase. Thus, low mar-

¹⁰It is, of course, true that the silver contract market is not as important economically to the Board of Trade as it is to COMEX, so that there would be less member opposition to its acting to curb activity in the silver contract market.

¹¹See Johnson, Philip (1982): *Commodities Regulation*, Little, Brown, Boston, Chap. 2, Sec. 2.70.

¹²There is a continuing debate, of course, about what constitutes an "emergency," and the industry, by its litigious approach, has perhaps made the Commission a bit gun-shy. See *Board of Trade v. Commodity Futures Trading Commission*, 605 F.2nd 1016 (7th Cir. 1979), cert. denied, 446 U.S. 928 (1980).

gins on futures do not “use up” credit that would otherwise be free to support more productive activities.¹³

Another related argument might be that lower margins reduce the cost of futures contracts relative to other investment instruments (such as stock), and therefore raise the (net) expected return on futures instruments. As a consequence, more savings or investment funds will flow into futures markets than would be the case if margins were higher.

However, this argument is of dubious validity as well. To begin with, all investments have at least two dimensions: return and risk. While one may be able to raise the expected return on an instrument through additional leverage, its riskiness is also likely to rise. With both a higher return and a higher risk, it is not clear that a futures contract is a relatively superior investment. Indeed, considering the fact that millions of individuals invest in common stock while only a relatively small number choose futures markets, a reasonable inference is that futures contracts are already a relatively unattractive investment—returns are too low to justify the risks.

In addition, implicit in the argument that futures margins are too low is the presumption that margin levels on other investments, such as stock, are “right.” There is, however, neither theory nor empirical evidence that can support this presumption. It may very well be that margins on stock should be lower, and not futures margins higher.¹⁴

Finally, even if lower futures margins did attract more funds into futures markets, there is no necessary connection between this financial flow and real spending in any sector of the economy. Real spending, such as on capital formation, is affected primarily by risk-adjusted real returns on such spending. Changes in relative prices among financial instruments will have little effect on real returns. Money and credit are highly fungible commodities, and will flow to where the real returns are highest, however lengthy and circuitous their route may be. It is, therefore, unlikely that futures margins will have any significant effect on either capital formation or the distribution of real spending in the economy.¹⁵

In summary, those who argue that low futures margins have negative macroeconomic externalities because they divert economic resources away from productive uses have a heavy burden of proof. Neither economic theory nor the available empirical evidence supports this view. Furthermore, although it has not been emphasized in this discussion, futures markets do perform certain socially beneficial functions that would have to be weighed against any alleged costs.

B. Additional Investor Protections

While there has always been some concern about protecting nonprofessional users of futures markets, renewed interest in this issue has been generated by the recent

¹³The argument is clearly not applicable to purchasers borrowing or using general credit lines to support their margin deposits. Higher margins here would increase the amount of credit needed to support futures transactions.

¹⁴Stock margins presently are between 50 and 70%. See Securities Exchange Act of 1934, section 7; 15 U.S.C. 78g.

¹⁵See, for example, the evidence cited with respect to other credit allocation regulations in *Government Credit Allocation*, Institute for Contemporary Studies, San Francisco, 1975, Chaps. 3 and 4; and Edwards, Franklin R., (1979): *Issues in Financial Regulation*, McGraw-Hill, New York, Chap. 7.

eight-month investigation by the Senate Permanent Subcommittee on Investigations, which reported a "recent tide" of fraud that has cost investors more than \$1 billion. This study focused on off-exchange futures contracts and options, and concluded "that the C.F.T.C. has been unable to stem the recent tide of commodity frauds, yet it systematically authorizes new areas of trading which may be subject to ever increasing fraud."¹⁶ Singling out commodity options as particularly troublesome, the committee recommended a continuation of the 1978 ban on such options.

In addition, there is considerable uneasiness about how prospective users of stock index futures and of options on such futures will fare. Many will almost surely be newcomers to futures markets, and may be uninformed about the significant risks associated with high leverage. Also, in securities markets brokers and dealers are subject to increasingly strict "suitability" and "know your customer" rules designed to protect customers, while in futures markets they are not.¹⁷

The "suitability" doctrine applicable to securities markets generally requires that a broker-dealer recommend to his customer only those securities transactions that he reasonably believes are suitable in light of the customer's financial position and investment goals.¹⁸ Similar suitability rules are also applicable to options trading. The Chicago Board of Options Exchange, Inc., in addition to requiring inquiry and suitability judgments similar to those of the foregoing SEC rule, requires a member recommending the sale of a put or an uncovered call to have a reasonable basis to believe that the investor has "such knowledge and experience in financial matters that he may reasonably be expected to be capable of evaluating the risks of such transactions. . . ."¹⁹ Finally, the National Securities Exchanges impose "know your customer" rules upon their members, placing an affirmative requirement upon them to inquire into a customer's occupation, investment objectives, and financial position.²⁰

Should such requirements be imposed on brokers and dealers in futures markets? This question reduces to two fundamental issues. Do the customer protection rules presently applicable to futures transactions provide less protection than is desirable, given the economic differences between futures and securities markets? Also, do rules such as "suitability" and "know your customer" requirements now provide effective protection for investors in securities markets, and, if they do, are the savings worth the costs associated with these rules?

An important section of the customer protection law applicable to futures transactions that is now in transition is section 4b(a) of the Commodity Exchange Act (7 U.S.C. section 6b 1980).²¹ This section makes it unlawful to cheat or to defraud, or

¹⁶"Citing Tide of Fraud, Senators Criticize C.F.T.C.," *New York Times*, July 14, 1982; see Hearings Before the Senate Permanent Subcommittee on Investigations, U.S. House of Representatives, 97th Cong., 2nd Sess. (February 23-25, 1982).

¹⁷While not discussed in this article, there are also differences in disclosure requirements and in insider-trading rules.

¹⁸Securities Exchange Act Rule 15b 10-3, 17 C.F.R. 240. 15b 10-3 requires that a SECO broker-dealer, in recommending trades, have "reasonable grounds to believe that the recommendation is not unsuitable for such customer after reasonable inquiry concerning the customer's investment objectives, financial situation and needs, and any other information known by such broker or dealer."

¹⁹CBOE rules 9.7 and 9.9, *CBOE Guide* (CCH), paragraph 2309. In addition, the National Association of Securities Dealers has a comparable suitability rule governing its members. See *NASD Manual*, Rules of Fair Practice, article III, section 2 (CCH), paragraph 2152.

²⁰See, for example, New York Stock Exchange Rule 405.2, *NYSE Guide* (CCH), paragraph 2405.

²¹For a more complete description of the protections available to futures customers, see Johnson, *op. cit.*, Chap. 1, section 1.88, and Chap. 5, sections 5.36-5.55.

attempt to cheat or defraud, another person in connection with a regulated commodity futures contract. In the past this provision has been interpreted to require an intent to deceive to establish a violation. However, it has never been clear what types of conduct (short of willfulness) constitute an intent to deceive under this regulation.

In a key recent decision the CFTC substantially broadened the kind of conduct it views as being in violation of section 4b(a). In that decision, *Gordon v. Shearson Hayden Stone, Inc.*,²² it found that the defendant-broker violated the Act because the broker failed to disclose the risks involved in a spread trading program that he recommended to his customer, and because he failed to have her sign a risk disclosure form. While the CFTC concluded that the broker acted in good faith, it found that he was negligent in his belief that no substantial risk existed in the spread transactions he recommended. This interpretation was affirmed on appeal.²³

In other decisions, the CFTC has imposed liability for negligent conduct for failing to disclose material facts relating to straddles,²⁴ for failing to transmit orders to the trading floor,²⁵ for failing to disclose the inherent limitations of stop-loss orders,²⁶ and for failing to monitor a customer's account and to notify the customer of losses.²⁷ It is not clear that these decisions will be upheld on appeal, but if they are there will be a substantial broadening of the protections available to futures customers: Negligent conduct by brokers and dealers, such as careless ignorance of the truth, may be sufficient to permit customers to recover their losses.

The present differences in the legal protections afforded securities versus futures customers must be viewed in the context of the characteristics of the participants in the two markets. Most importantly, the number of small, unsophisticated users of futures markets is trivial compared with securities markets. Thus, the potential benefits of greater customer protection are considerably less in futures markets than in securities markets.

Futures markets, however, may yet undergo a metamorphosis. If the new futures instruments being introduced succeed in attracting more of the same kinds of customers now found in securities markets, the distinctions between these markets can be expected to erode.

Consumer protection regulation, in futures markets as well as in other markets, is basically a cost-benefit issue. To protect customers regulatory restrictions must be imposed that entail both direct and indirect costs. The benefits are primarily the customers' losses that would have been incurred had it not been for such regulations. These benefits must be weighed against the direct and indirect costs of regulation. Which way the scales tip is a function of the nature of the market, its customers, our social philosophy, and so forth.²⁸

²²*Shearson Loeb Rhoades, Inc. v. Commodity Futures Trading Commission, Gordon v. Shearson Hayden Stone, Inc.*, 2 Comm. Fut. L. Rep. (CCH), 21,16 (CFTC April 10, 1980) affirmed on alternative grounds sub. nom. 9th Cir., No. 80-7217 (February 17, 1982).

²³*Ibid.*

²⁴*Lahency v. Murlas Bros. Commodities, Inc.*, 2 Comm. Fut. L. Rep. (CCH), 21,045 (May 12, 1980).

²⁵*Clampitt v. E. F. Hutton & Co.*, 2 Comm. Fut. L. Rep. (CCH), 21,120 (September 19, 1980).

²⁶*Yameen v. Madda Trading Co.*, 2 Comm. Fut. L. Rep. (CCH), 21,125 (October 8, 1982).

²⁷*Avis v. Shearson Hayden Stone, Inc.*, 2 Comm. Fut. L. Rep. (CCH), 21,379 (April 13, 1982).

²⁸In evaluating investor protection regulation there is the further issue of the relative weights to attach to social benefits as opposed to purely private benefits (or redistributions of wealth). For example, if investor protection regulations prevent unsophisticated investors from losing money (or from transferring their wealth to winning investors), that may be viewed as largely a private benefit. If as a result of such protections, however, there is greater

The second issue is whether rules such as "suitability" and "know your customer" requirements have been cost effective in securities markets (or have been effective at all in protecting customers). There has been no study of the costs and benefits of such rules, and none is likely. Data, measurement, and conceptual difficulties militate against it. Take, for example, suitability requirements. These may save some people from themselves, but may prevent others from using securities (or futures) markets who would benefit from using them. How are we to measure these benefits and costs? Or, in evaluating mandatory disclosure requirements that require brokers and dealers to disclose critical facts and information to customers so that customers can evaluate the risks involved, how can we account for differences in customers' predisclosure levels of understanding, or for differences in the skill and integrity of brokers in communicating such information? Also, all of these rules entail monitoring, enforcement, and compliance costs, which are difficult to measure.

These difficulties suggest that a fundamental objective of customer protection regulation should be to give brokers and dealers the proper incentive to disclose to customers what is relevant and important for them to know. Hard-and-fast rules for complicated transactions like those in futures markets are unlikely to be effective, and may even be counterproductive. The key is to develop an institutional structure that gives brokers and dealers the incentive to be informative and to treat customers fairly. (This is an avenue of inquiry that has not been pursued in futures markets, nor in any other financial market, for that matter.)

It is obvious that neither I nor anyone else is in a position to make informed judgments about the wisdom of additional investor protection regulations. Nevertheless, the discussion in this article suggests three comments. First, as pointed out earlier, futures markets are the creation of self-regulation. Without self-regulation these markets could not operate as they do. Thus, it seems sensible not to allow the proliferation of off-exchange, unregulated, "futures" instruments. Second, a policy goal should be to foster and maintain a highly competitive environment among futures brokers and dealers. Keenly competitive financial and futures markets may be the best form of customer protection, since competition encourages the disclosure of information and the fair treatment of customers. Lastly, means must be found to educate potential users of futures markets. If users are well-informed, brokers will also have to be. While many futures exchanges already conduct extensive educational programs, more needs to be done.

In summary, the issue of whether additional investor protections are needed is not an easy one. We have a very impressionistic view of the facts, and almost no understanding of how such protections have worked in securities markets. There are, nevertheless, strong feelings on both sides, as well as sharp ideological differences. In addition, we can be sure that there will be a steady trickle of "horror" stories to fuel these passions. It is, in short, an issue that will not go away. Thus, both government regulators and the futures industry must give these issues serious consideration, and must attempt to evaluate the alternatives in a systematic way.

public participation in futures markets, and as a consequence more liquid futures markets, there is a social benefit. Furthermore, if "fairness" itself is viewed as a social benefit, this may tip the scales toward having such protections.

IV. IMPLICATIONS AND SUGGESTIONS

The tension between government regulation and self-regulation in futures markets will not disappear and is likely to intensify as public participation in these markets grows. A random economic shock, a speculative bubble, or a headline-catching fraud could quickly tip the regulatory balance towards greater federal control. It is important, therefore, that a longer-term view of current problems be taken, and that some basic principles and procedures be developed to resolve conflicts between government and self-regulation.

The analysis and discussion in this article suggest a few such guiding principles. First, there should be a presumption in favor of industry self-regulation. Unless one or more of the deficiencies associated with self-regulation that are discussed here are clearly present, the presumption should be that self-regulation is more cost-effective.²⁹ Self-regulation generally has worked well in the past, and can continue to do so in the future.

Second, futures institutions and markets are beginning to overlap with other financial institutions and markets, just as in commercial banking, investment banking, insurance, and other financial industries. As a result, there are growing jurisdictional conflicts among regulatory authorities. Different and unequal regulations are applied to what are seemingly similar kinds of financial transactions. A second basic principle, therefore, is that when such regulatory conflicts arise we should not automatically apply the most restrictive regulations to all financial institutions and markets. These occasions should be used, rather, to evaluate the conflicting regulations on their merits. For example, with respect to federal margin-setting authority, the introduction of stock index futures should be an occasion to evaluate the effectiveness and usefulness of the Federal Reserve's present margin-setting powers with respect to securities markets, not one to extend mindlessly federal regulation. An overriding objective is obviously to use government regulation only when it is necessary to protect the public interest.

Finally, it is important that predictable and dependable lines of communication be established among all regulatory bodies now involved with futures markets. Communication should not be left to chance, or to the urgency of crisis. The "Silver Bubble" of 1980 clearly shows that better communication among industry regulators themselves (such as clearing associations) and between them and the CFTC would result in more effective regulation; everyone is harmed when this does not occur.

To achieve this a Working Committee on Futures Markets Regulation should be created, consisting of representatives of the major self-regulatory institutions. This committee should meet regularly to establish a dialog concerning major regulatory issues, both present and future. Its major purpose should be to develop a frank and informal exchange of views about regulatory issues and philosophies. There is a

²⁹While there has not been, admittedly, much research on the relative merits of self-regulation, there is an extensive body of research which supports the view that the private sector can perform many governmental functions more efficiently than can government. See, for example, Savas, E. S. (1974): "Municipal Monopolies v. Competition in Delivering Urban Services," *Urban Analysis*, 2: 93-116; Savas, E. S. (1979): "Public v. Private Refuse Collection: A Critical Review of the Evidence," *Urban Analysis*, 6: 1-13; Edwards, F., and Stevens, B. (1978): "The Provision of Municipal Sanitation Services by Private Firms: An Empirical Analysis of the Efficiency of Alternative Market Structures and Regulatory Arrangement," *The Journal of Industrial Economics*, 27(2) (December): 133-147.

special need for greater communication and cooperation in the futures industry, since there is not a single, unified self-regulatory institution in futures markets but many such institutions.³⁰

In summary, as the breadth and economic importance of futures markets expands, so must our thinking about how best to regulate them. Both the industry and the government have a responsibility to develop effective and low-cost regulatory policies.

³⁰A common fear about this kind of industry arrangement is that it will diminish competition within the industry, to the detriment of the public. If this is a significant concern the committee could include some government officials as well. In addition, competition among self-regulatory institutions such as clearing associations may not be of great consequence in any case. Also, all industry agreements would be subject to the antitrust laws, and to CFTC approval.