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Self-Regulation and Government Regulation of Futures and Options Markets: Introduction

The Commodity Futures Trading Commission (CFTC) was established by Congress in 1974 and charged with responsibility for government oversight of the futures industry in the United States. In 1978 and 1982, the Congress reviewed the agency's performance and reauthorized its mandate. The third reauthorization of the CFTC is taking place in 1986.

During each reauthorization process, a variety of issues pertaining to the regulation and performance of futures markets are debated. These issues generally relate to the degree of government regulation of the markets, the effectiveness of the self-regulatory activities of the exchanges, the jurisdiction of different government agencies over the futures industry, the role and performance of the markets, and new product development. Intelligent reauthorization debate requires that the participants have a good grasp of these issues.

To promote an understanding of issues raised during the 1982 reauthorization and likely to be discussed during the 1986 reauthorization, the Chicago Board of Trade in 1984 funded a group of independent research studies by a handful of top-flight economists, under the coordination of D. Gale Johnson and Lester G. Telser. The studies presented here are intended to help the Congress, the CFTC and other government agencies interested in the futures industry, academics, and participants in the market to be more informed on a number of key issues for the 1986 reauthorization.

The choice and definition of issues for a group of studies of this kind pose numerous challenges. Which issues are key? Will the key issues change or be redefined even before the studies have been completed? Which issues can be hammered into a well-defined question or questions that are susceptible to rigorous economic analysis? Policymakers tend to be interested in particular decisions that must be made in light of particular institutional arrangements at a point in time. Researchers tend to seek out the more general and repetitive aspects of issues that can be analyzed in the light of established theory or that can provide adequate data for empirical testing.

Given these numerous challenges and a constantly changing set of information, the authors of these studies have done a very fine job of balancing relevance and rigor. Some of the papers are clearly at the cutting edge of key policy issues, while others provide information and extensions of past research on futures issues. All provide thoughtful analysis that should inform policymakers and stimulate thinking about the functions of futures markets and the effects of various regulations on these markets. Policymakers and students of futures markets will find these papers interesting and thought provoking.

The first three papers provide insights into the role of futures markets. The first paper, "Futures and Actual Markets: How They Are Related," by Lester G. Telser, presents an analogy between futures markets and monetary phenomena that sheds new light on both the role of the futures markets and the effects of futures on the underlying cash markets. For example, Telser's discussion illustrates the beneficial effect that both futures markets and money have on real income in the economy, an effect due to the savings in real resources that both make possible. Next, Robert J. Barro discusses the potential utility of price index futures in "Futures Markets and the Fluctuations in Inflation, Monetary Growth, and Asset Returns." Like Telser, Barro provides evidence that points to the positive contributions of futures markets to the macroeconomy, including their positive effect on information flows and resource allocation. Kenneth R. French, in "Detecting Spot Price Forecasts in Futures Prices," provides new insights into the capacity of futures markets to forecast future spot prices, a question that has intrigued economists for years. After studying a number of individual nonfinancial commodity markets, he concludes that the forecast power of futures markets is dependent on the variability of the expected and actual spot prices.

The next three papers address broad issues relating to the interplay between futures exchanges and government regulators. In a two-part paper, "The Political Economy of Futures Market Regulation," B. Peter Pashigian examines the sources and evolution of farm opposition to futures markets over the years. He then estimates how jurisdictional conflicts between the CFTC and the Securities and Exchange Commission (SEC) have affected seat prices at the Chicago Board of Trade, the Chicago Mercantile Exchange, and the Chicago Board of Options Exchange. Daniel R. Fischel examines the CFTC's new product approval process in "Regulatory Conflict and Entry Regulation of New Futures Contracts." Fischel concludes that there is no theoretical or empirical basis for the CFTC's regulation of new product development in futures markets. Even if futures markets were prone to systematic fraud or manipulation problems—which Fischel says is unlikely—he determines that prior approval of all new futures contracts is probably an inefficient regulatory response. Frank H. Easterbrook also argues for less government regulation in "Monopoly, Manipulation, and the Regulation of Futures Markets." Easterbrook's analysis suggests that the process of developing new contracts at futures exchanges results in minimizing the potential for monopoly and manipulation. The demands and diverse interests of the traders themselves, who are involved in contract design, lead the exchange to establish optimal precautions. Accordingly, he sees no strong justification for imposing regulations on trading or restricting the creation of new products.

The final two papers address questions also analyzed in extensive government studies. The Futures Trading Act of 1982 required the CFTC to examine the concept of "insider trading" to determine its relevance to the futures industry. In his paper "An Analysis of the Role of 'Insider Trading' on Futures Markets" Sanford J. Grossman addresses the same issue and argues that the rationale for regulating insider trading in the securities markets—that is, the existence of a fiduciary responsibility that corporate officers have to shareholders—does not exist in futures markets. The basis for his analysis is the model of a futures market as a forum for "price discovery," whereby buyers and sellers possessing information from various sources determine a competitive price that represents an aggregation of what they think about the future value of a commodity. Grossman, like Easterbrook, concludes that an exchange has the proper incentives to address potential abuses because, if it does not address these abuses, the quality of its product will decline, adversely affecting trading volume. In "The Effects of Changing Margin Levels on Futures Market Activity, the Composition of Traders in the Market, and Price Performance," Michael L. Hartzmark covers much of the same ground as the Federal Reserve's "Review and Evaluation of Federal Margin Regulation," submitted to Congress in January 1985. Hartzmark shows that increasing margin levels has a predictable, negative effect on market activity, a significant but unpredictable effect on trader composition of the market, and an uncertain effect on price behavior. Overall, his analysis supports the view that margins should be used as performance bonds only—that is, as a mechanism to prevent trader default—rather than as a tool to alter the composition of market participants.

These studies add significantly to the futures market literature and help to define and clarify the issues debated in the 1982 reauthorization of the CFTC. During the 1986 reauthorization process, it is essential that these complex issues be fully understood by all participants in the debate. The viability and efficiency of the futures markets depends on public confidence fostered by an efficient self-regulatory process. Collectively, the studies presented here provide much evidence in favor of self-regulation as it is now being practiced and raise serious questions about the costs imposed by existing and proposed regulatory schemes on the current functioning and future development of futures markets.