

Regulatory Conflict and Entry Regulation of New Futures Contracts

When an automobile manufacturer decides to introduce a new product such as a new model of car, it is free to do so. It does not have to convince a regulatory body that the new model has an economic purpose or is in the public interest. Nor does it have to demonstrate that the car will not break down excessively or that consumers who purchase the car are making a sound financial decision.

When an exchange that sells transactional services decides to offer a new product such as a new futures contract, however, it must convince one or more regulatory agencies that the proposed contract meets each of the above tests. Under guideline 1 of the Commodities Futures Trading Commission (CFTC),¹ every application by an exchange for a new futures contract must contain a description of the cash market, an analysis of the terms and conditions of the contract, an explanation of how the contract would fulfill an economic purpose, and a statement of how the contract furthers the public interest. As required by statute, the CFTC has focused primarily on the susceptibility of a particular contract to manipulation. The larger the deliverable supply, the lower the probability of manipulation.

1. Guideline 1 was promulgated in 1975 as an "interpretative statement" of the requirement in the Commodity Exchange Act that trading of the contract for which designation is sought not be contrary to the public interest (7 U.S.C. §7[g] [1982]).

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Entry restrictions are generally regarded as inefficient. Yet exchanges that sell transactional services face substantial entry barriers when they decide to introduce a new product such as a new futures contract. This paper argues that this barrier to entry in futures markets should be eliminated.

The Securities and Exchange Commission (SEC) has also expressed concern about certain types of new futures contracts, particularly futures on industry subindices and on municipal bond indices. In addition to the traditional focus of the CFTC on manipulation, the SEC has expressed concern over the possibility that these proposed contracts could be used to evade regulatory prohibitions on insider trading, margin rules, suitability rules, and other regulations that, the SEC claims, protect consumers.

Recent years have witnessed an increasingly heated political and legislative debate on the issue of which agency, the CFTC or the SEC or some combination, should regulate entry of new futures products. Almost completely overlooked in this jurisdictional battle between the two agencies is the prior and more important question, Why is the introduction of new futures products different from the introduction of other types of products such as new models of cars?

I argue that no theoretical or empirical basis exists for the current regulation of new futures products. After summarizing the history of entry regulation in Section I, I discuss in Section II the criteria that determine the prevalence of fraud (manipulation) in a particular market. I conclude that fraud is unlikely to be a systematic problem in futures markets. Moreover, even if futures markets were prone to fraud or some other type of market failure, prior government approval of all new futures contracts is in all probability an inefficient regulatory response.

The SEC's position concerning the perils of new types of futures contracts is discussed and found to be without merit in Section III. An alternative explanation for the SEC's actions is tentatively suggested. The recurring proposal for a merger of the CFTC and the SEC is critically analyzed in Section IV.

I. History of Entry Regulation of New Futures Contracts

A. *From the Grain Futures Act to the Commodity Futures Trading Commission Act*

Under the Grain Futures Act of 1922,² an exchange had to be designated a contract market in order for it to trade specified commodities. Exchanges were required to adopt certain regulations and file certain reports before they could be designated as a contract market by the secretary of agriculture. In theory, a commission composed of the secretary of agriculture, the secretary of commerce, and the attorney general had the power to suspend or revoke the contract-market designation if a board of trade violated any regulatory requirement. Because of the drastic nature of this sanction, however, it was rarely exercised.

2. Grain Futures Act, ch. 369, 42 Stat. 998 (1922).

The Commodity Exchange Act (CEA) of 1936³ expanded the scope of federal regulation by giving regulators powers other than revocation of contract-market designation. Futures regulation was extended to new commodities, new penalties against fraud and manipulation were enacted, and the power to set speculative limits was created. The CEA also prohibited all trading of options on regulated commodities. The CEA did little, however, to alter the contract-market designation process that had been established in 1922. Exchange designation was still mandatory before a futures contract could be traded. The secretary of agriculture was given exclusive authority to revoke or suspend contract-market designation.

Although certain individual commodities were added over time to the list of commodities for which contract-market designation was required, many commodities were completely unregulated by the CEA. The situation changed dramatically, however, with the Commodity Futures Trading Commission (CFTC) Act of 1974.⁴ In response to a large increase of futures trading, particularly in unregulated commodities, the coverage of the CEA was extended to include not only the previous unregulated commodities but also "all other goods and articles [except onions], and all services, rights, and interests in which contracts for futures delivery are presently or in the future dealt with."⁵ Thus the prerequisite of federal approval was extended to the trading of all futures contracts. In addition, the CFTC Act provided that contract markets had to demonstrate that trading of the proposed contract for which designation was sought would not be contrary to the public interest.⁶ Guideline 1, developed a year later, in 1975, incorporated this standard.

One of the major concerns in connection with passage of the CFTC Act was in whom this new regulatory authority should be vested. The Department of Agriculture advocated a new agency under its control; others advocated placing the regulation of futures trading within the SEC. Eventually, Congress decided to create a new independent federal agency, the CFTC, to assume the expanded regulatory responsibilities. Congress was clear, however, that it intended the CFTC, not to usurp power from other federal agencies, but rather to fill regulatory gaps.⁷

B. The 1978 Reauthorization

Although the SEC did not participate directly in the legislative process concerning the 1974 act, it proposed in 1975 an amendment to the

3. Commodity Exchange Act, ch. 545, 49 Stat. 1491 (1936).

4. Commodity Futures Trading Commission Act, Pub. L. No. 93-463, 88 Stat. 1389 (1974) (codified as amendments to 7 U.S.C. §§ 2-22).

5. Commodity Exchange Act, 7 U.S.C. § 2 (1982).

6. Commodity Exchange Act, 7 U.S.C. § 7(g) (1982).

7. 120 Cong. Rec. 34736 (remarks of Rep. Poage).

Securities Exchange Act that would vest exclusive jurisdiction in the SEC for securities/commodities to relieve the "ambiguity" of the CFTC.⁸ The SEC's attempt grew out of the CFTC approval in 1975 of a futures contract in mortgage-backed certificates guaranteed by the Government National Mortgage Association (GNMA) to be traded on the Chicago Board of Trade. The CFTC took the position that it had exclusive jurisdiction over all futures trading even if the underlying instruments were "securities." Congress⁹ and the courts¹⁰ agreed with the CFTC, however, and rejected the SEC's claim to jurisdiction over new and developing futures and options investments.

The competing jurisdictional claims arose again in connection with the legislative debate in 1978 concerning whether the CFTC should be reauthorized. The SEC again took the position that all forms of trading in securities, including futures and options on securities, be vertically integrated in the SEC.¹¹ Congress, however, again rejected this proposal. The Futures Trading Act of 1978¹² basically reaffirmed the 1974 act, giving the CFTC exclusive jurisdiction over trading in futures markets, including futures on registered securities. The 1978 act also enacted into law the CFTC ban on commodity options promulgated earlier that year.¹³ By 1981, however, the CFTC announced a proposal for a 3-year pilot program on commodity options to be traded on domestic exchanges.¹⁴ Options trading was restricted to a limited number of nonagricultural commodities subject to CFTC approval.

C. *The Jurisdictional Accord and the 1982 Amendments*

The Futures Trading Act did little to resolve the jurisdictional dispute concerning the regulation of futures contracts. The SEC continued to argue that futures and options trading on both registered and exempt securities should be within its jurisdiction. With the approach of the 1982 reauthorization date for the CFTC, the SEC and the CFTC decided to resolve jurisdictional conflicts. The Jurisdictional Accord developed by the respective SEC and CFTC chairman John S. R. Shad

8. Letter of Ray Garrett, Jr., chairman, SEC, to Harley O. Staggers, chairman, House Committee on Interstate and Foreign Commerce (February 14, 1975), summarized in Guttman (1970, p. 12, n. 69).

9. S. Rep. No. 73, 74th Cong., 1st Sess. at 5, reprinted in *United States Code Congressional and Administration News*, vol. 1 (1975), p. 147; 121 Cong. Rec. 9244 (1975) (remarks of Rep. Bergland).

10. For a sampling of cases upholding exclusive CFTC jurisdiction, see, e.g., *SEC v. Univest, Inc.*, 405 F. Supp. 1057 (N.D. Ill. 1975); *SEC v. American Commodity Exchange, Inc.*, 546 F.2d 1361 (10th Cir. 1976); *International Trading Ltd. v. Bell*, 556 S.W.2d 420 (1977), *cert. denied*, 436 U.S. 956 (1978).

11. Extend Commodity Exchange Act: Hearings on H.R. 10285 Before the Subcomm. on Conservation and Credit of the House of Comm. on Agriculture, 95th Cong., 2d Sess. at 183 (1978) (statement of Harold Williams).

12. Pub. L. No. 95-405, 92 Stat. 865 (codified in scattered sections of 7 U.S.C.).

13. 17 C.F.R. §32.11 (1983).

14. 46 Federal Regulation 33, 293, (1981).

and Phillip M. Johnson was published in February 1982. Its main provisions were as follows.

1. The CFTC will continue to regulate all futures contracts (and all options on those futures) traded on designated exchanges.
2. The SEC will regulate options on *all* securities and on certificates of deposit (and on groups or indices of securities or certificates of deposit).
3. The CFTC will regulate futures contracts on exempted securities, excluding municipal securities, and on "broad-based" indices on any securities (as well as options on those futures).
4. The CFTC may designate as a contract market only those futures contracts based on broad groups or indices that (a) provide for settlement in cash or by means other than receipt of a corporate or municipal security; (b) are not likely to produce manipulation in the futures markets or in related markets, that is, those for an underlying security, option on such security, or option on a group or index including such securities; and (c) have as an underlying group or index a widely published measure and reflection of the market for all publicly traded equity or debt securities or a substantial segment of such market.
5. The CFTC must consider the views of the SEC with respect to futures contracts on groups or indices of securities when designated such contracts.
6. No futures contracts (or options on futures contracts) on individual corporate and municipal securities will be permitted.
7. The SEC will regulate options on foreign currency traded on national securities exchanges.
8. The CFTC will regulate options on foreign currency traded on national commodities exchanges.
9. The SEC will regulate the capital formation stage of commodity pools.¹⁵

The accord was significant in that it provided a greater role for the SEC in several important areas, such as futures contracts on groups of securities and certain types of options, than was previously recognized. But the accord was almost immediately called into question by the decision of the Seventh Circuit in *Board of Trade v. SEC*.¹⁶ There the Court held that an order by the SEC approving the Chicago Board Option Exchange's proposal to trade GNMA options was invalid because the SEC lacked jurisdictional authority to approve trading of options on exempted securities because they were "commodities"

15. CFTC and SEC Joint Explanatory Statement (February 2, 1982), reprinted in [1980-1982 Transfer Binder] *Commodity Futures Law Reporter* (Commerce Clearing House), ¶ 21, 332.

16. 677 F.2d at 1137 (7th Cir. 1982).

within the meaning of the CEA. The accord was dismissed as irrelevant: "We cannot allow the CFTC and SEC to reappportion their jurisdictions in the face of a clear, contrary statutory mandate."¹⁷

All doubts concerning the validity of the accord, however, were eliminated with the Futures Trading Act of 1982.¹⁸ Indeed, Congress went further than the accord in giving new power to the SEC by granting the SEC veto power over designation of stock index futures contracts for contract applications filed on or after December 9, 1982 (earlier applications were subject only to SEC recommendations).¹⁹ Moreover, Congress defined the standard that should be applied in designating futures contracts that are based on "a group or index of securities." The CFTC is authorized to approve such contracts if the following three requirements are met: (1) settlement of or delivery on such contract (or option on such contract) is in cash; (2) trading in such contract shall not be readily susceptible to manipulation; and (3) the group or index of securities shall consist predominantly of unaffiliated issuers and shall reflect a substantial segment of publicly traded equity or debt securities.²⁰ The purpose of these requirements was to decrease the probability that the new contracts would be manipulated.

The Futures Trading Act of 1982 also repealed the prohibition on the trading of options on specifically enumerated commodities that dated from the CEA.²¹ In addition, Congress enacted amendments to the federal securities laws that authorized the SEC to approve and regulate options on stock indices or groups.²²

D. Developments since 1982

Jurisdictional bickering has continued since the 1982 act. Much of the controversy has been related to the proper standard for approval of futures contracts on industry indices and subindices. Around the time of the 1982 act, both the Chicago Board of Trade and the Chicago Mercantile Exchange proposed futures contracts on a variety of industry indices and subindices, including the energy, high-technology, utilities, financial services, chemical, drug and health care, and electronics industries. The SEC lodged a variety of objections to these proposed contracts, the most important being that they were susceptible to manipulation and would allow users to evade the prohibition against insider trading in federal securities law and otherwise disrupt the regulation of securities markets. As one SEC commissioner stated in justifying his agency's opposition to new futures contracts: "The SEC's comprehensive regulation of the securities markets could be

17. 667 F.2d at 1142 n. 8.

18. Pub. Law No. 97-444 (1982).

19. H.R. Rep. No. 964, 97th Cong., 2d Sess. at 2-3 (1982).

20. 7 U.S.C. § 2a(ii) (1982).

21. Commodity Exchange Act, 7 U.S.C. § 6c(c) (1982).

22. Pub. Law No. 97-303, 96 Stat. 1409 (1982).

undermined generally, to the point of becoming irrelevant, by futures contracts that the public or its investment advisers perceive as, for most purposes, adequate surrogates for traditional stock market investments. Moreover, the products themselves would not compete on the basis of economic merit, but on the basis of regulatory differences."²³

In January 1984, the SEC and the CFTC again settled their differences by establishing guidelines for industry indices. The minimum qualifications for proposed contracts are as follows.

1. The index must be composed of domestic equity securities of at least 25 issuers.
2. The aggregate capitalization of the securities comprising the index must be at least \$75 billion.
3. In a capitalization-weighted index, no single security within the index may have a capitalization exceeding 25% of the aggregate capitalization of all securities within the index.
4. A security may not be a part of the index if its weighted percentage in the index exceeds three times its percentage weight of total index capitalization.
5. In a capitalization-weighted index, the aggregate capitalization of the three securities having the highest capitalization within the index may not exceed more than 45% of the capitalization of all securities within the index.²⁴

The Chicago Board of Trade challenged these guidelines as inconsistent with the explicit criteria in the 1982 act, but the suit was dismissed on procedural grounds.

A separate controversy has involved a proposed futures contract on a municipal bond index. The SEC has not objected to this contract, provided additional investor-protection measures are adopted for the benefit of investors who are "financially unsophisticated and averse to risk."²⁵

II. Why Have Entry Regulation of New Futures Contracts?

The wisdom of entry regulation of new futures contracts is generally assumed.²⁶ The most common justification for such regulation is the

23. Statement of Commissioner James C. Treadway, Jr., made at a public meeting of the CFTC regarding the application of the CME for designation as a contract market for proposed futures contract on Standard & Poor's energy index (Washington, D.C., December 6, 1983).

24. 49 Fed. Reg. 2884.

25. Letter from George A. Fitzsimmons, secretary, SEC, to Paula Tosini, director, Division of Economics and Education, July 23, 1984.

26. Entry regulation is analyzed critically in Silber (1981) and somewhat less so in Anderson (1984). Both Silber and Anderson approach the issue of entry regulation from a somewhat different perspective than contained herein.

prevention of manipulation or fraud. How can anyone be in favor of not deterring fraud? The economic of information suggests, however, that manipulation is not likely to be a serious problem in futures markets. Moreover, even if a "problem" did exist, prior government approval of all futures contracts is almost certainly the wrong solution. Nor do any of the other possible reasons for limiting entry justify the prior government approval system. Notwithstanding the lack of any convincing justification for entry restrictions in futures markets, such restrictions do impose substantial costs.

A. New Contract Design and Fraud in Unregulated Futures Markets

An organized exchange sells transactional services. New futures contracts are a species of transactional services. The main regulatory concern appears to be that, if entry is not regulated, an excessive amount of fraud will result. If there is an inadequate amount of deliverable supply or an index is not sufficiently broad, the argument runs, the proposed contract can be manipulated, and consumers will be defrauded.

Markets do not work perfectly, and it is quite possible that some futures contracts will not work well either because they are prone to manipulation or otherwise. But this is true of all products. The relevant inquiry is whether the social costs of imperfect contract design can be reduced by regulation without imposing even greater costs. This inquiry in turn requires some understanding of the social costs of both imperfect contract design and regulation.

There is now a literature on the probability of fraud in a given market that facilitates informed judgments on the need for regulation.²⁷ Several characteristics of futures markets suggest that fraud will not be a major problem in the absence of entry regulation.

1. *Observability.* The more observable a particular product characteristic, the less likely consumers can be fooled. It is extremely difficult to deceive consumers with respect to the number of rooms in a house, for example, because consumers can ascertain the truth by counting themselves.

At the other extreme are product characteristics that are very difficult to observe. A representation by an automobile mechanic that a given part should be replaced once the car has been taken in for other work, for example, is notoriously difficult to verify at low cost. Thus the probability that consumers will be misled is much higher than in the case of the house.

27. For a representative sample of this literature, see Easterbrook and Fischel (1984), Schwartz and Wilde (1979), Posner (1973), Nelson (1974), and Darby and Karni (1973).

Design of futures contracts is much closer to the house than to the automobile mechanic example. The number of stocks in an index, the deliverable supply, the delivery locations, and so forth are all observable. Thus it is unlikely that exchanges will be able to fool consumers by designing defective contracts that are prone to manipulation.

2. *Reputation of the seller.* The greater a seller's incentive to maintain a reputation for honesty and fair dealing, the less likely the seller will engage in deceptive practices. A well-established large department store is less likely to misrepresent product quality than a transient street vendor selling the same product.

Organized exchanges have strong incentives to maintain good reputations. The long-run profitability of the sale of transactional services is highly dependent on the volume of trade, which in turn will be maximized if consumers do not suspect the exchange's integrity. The survival of an institution, such as the Chicago Board of Trade for a century, is itself evidence that the exchange has acted to maintain its reputation. Design of faulty contracts would cause consumers to lose confidence in the faulty contract and possibly all other contracts traded on the exchange.

3. *Repeat transactions.* The present value of engaging in deceptive practice is greatest for "one-shot deals." Victims of fraud are not likely to be repeat players in the same game. An organized exchange, by definition, is dependent on repeat business for survival.

4. *The role of informed consumers.* A successful fraud or manipulation is dependent on victims being uninformed until the harm has been done. If this were not the case, potential victims could refuse to transact or change appropriate compensation for the risks they face.

Informed traders thus reduce the probability of fraud. Particularly since aspects of contract design are observable, informed traders can refuse to transact, thus causing the contract to fail, or only transact on terms that reflect the probability of a manipulation. Uninformed market participants transact on the same terms (or not at all if the contract fails or is never offered) as those who are informed. The informed, in other words, protect the uninformed.

The relevant inquiry in assessing the need for regulatory intervention in connection with imperfect contract design, therefore, is not whether all consumers are informed but rather whether enough are informed so that the exchanges act as if consumers are informed. Causal empiricism suggests that sophisticated market participants are responsible for a high percentage of volume in futures trading. By their actions in deciding what contracts to trade and on what terms, uninformed traders are given substantial protection from defective contract design.

5. *Competition among sellers.* If one exchange were to introduce a defective contract, other exchanges have incentives to introduce a superior version to maximize its profitability. Moreover, many contracts that are not identical, such as an option and a futures contract on the same underlying index, are nevertheless close substitutes. The existence of such close substitutes makes it unlikely that defective contracts can survive over time.

*B. The Requirement of Prior Government Approval
of All Futures Contracts*

The discussion thus far has established that the problem of manipulation or fraud is really a problem of inadequate information and that exchanges have neither the ability nor the incentive to fool consumers systematically. This does not mean, however, that manipulation will never occur. It is theoretically possible for a group of traders to discover and exploit a defect in contract design not apparent at the time the contract is introduced. More likely, the possibility of manipulation can be recognized at the time the contract is introduced, but the "defects" in the contract cannot be changed without eliminating the contract's usefulness.

This latter situation highlights the fallacy of equating the possibility of manipulation with a need for regulation. There is an obvious trade-off between a carefully specified contract that is useful to hedgers but susceptible to manipulation and a broad contract that is difficult to manipulate but of no use to hedgers. Exchanges must balance these two objectives in choosing product quality. Exchanges have strong incentives to design contracts that have the characteristics that consumers demand because they bear the costs if the contract is a failure. Of course, the best incentives *ex ante* do not ensure the success of proposed contracts *ex post*. Many will fail just as many other new products flop. The relevant point, however, is that there is no reason to believe that the likelihood that decisions of exchanges concerning product quality can be improved on by regulation is any greater than with respect to product quality decisions by other market participants such as what model of new car to introduce. Indeed, the opposite is true. Because exchanges, unlike regulators, are disciplined by markets and bear the costs of their product-quality decisions, they have superior incentives to design products that consumers demand.

Thus the proper role of government in relation to contract design is extremely limited. Not only do exchanges have incentives to design products that consumers want, but the number of well-accepted cases of successful manipulations is also extremely low. Moreover, no guarantee exists that regulation has deterred manipulation. Just as there have been numerous major frauds after the passage of securities regulation, so there have been alleged manipulations before and after various stages of commodities regulation.

If there is a role for government, it almost surely is not in prior approval of all contracts. The main problem with prior approval, like all substantive regulation of contract terms, is that it reduces the feasible set of contracts that fully informed individuals can enter into. Refusal to allow contracts to trade because of the possibility that they will be manipulated, for example, denies hedgers who might be willing to bear this risk to obtain a closer fit the opportunity to trade.

Deterrence by the use of high penalties is an alternative, and superior, regulatory response to the perceived problem of manipulation. Since successful manipulations appear to be rare, it is cheaper to penalize "manipulators" who engage in wrongful conduct than to raise the cost of all futures trading by a system of prior government approval. Deterrence is achieved without limiting the choices of consumers concerning product quality.

C. Other Possible Justifications for Entry Regulation

Although the prevention of manipulation is the common justification for entry regulation, other justifications have been or could be given. Some of these other justifications are considered in summary fashion below.

One of the most common arguments for entry regulation is that futures markets impair capital formation. The argument is nonsense. Funds used in futures trading do not disappear but rather are shifted between traders; the amount of aggregate funds available for investment is unchanged. A variant of this argument is that futures markets divert time and attention away from more productive activities. Under this theory, television should be abolished so that more time would be available for productive activities. Even if the social benefits of risk shifting and price discovery are ignored, there is no reason to believe that futures markets will reduce the number of profitable ventures elsewhere in the economy.

A somewhat related argument is that unregulated futures markets produce too many futures contracts. Although it is possible to construct models demonstrating that unrestricted competition will lead to a socially excessive number of firms and product types, it is highly unlikely that entry regulation will improve the situation. Regulators have no more tools to analyze how many futures contracts are enough than they do tools to analyze how many brands of toothpaste are enough. Moreover, existing regulation appears to be biased in favor of allowing new contracts very similar to existing contracts as opposed to more innovative contracts thus exacerbating any possible problem that exists.

A final possible justification for some form of entry regulation is to protect property rights in information. If successful contracts can be easily copied, innovation will be discouraged because of the decrease in the private returns on research and development. The need to en-

courage innovation by providing some type of property right in privately produced information lies at the core of much of the law of intellectual property, including the patent and copyright systems. Again, however, the fact that duplicative contracts are favored under the current regulatory scheme suggests that protecting property rights is not a plausible explanation for existing regulation. Moreover, a property-right-based scheme would give developers of new contracts the right to sell or license their innovation, unlike the situation under current rules.

D. The Costs of Entry Regulation

The lack of justification for entry restrictions in futures markets would be unimportant if such restrictions were costless. But in fact they are very costly. Guideline 1 requires exchanges to incur the costs necessary to prove to the CFTC's satisfaction that a proposed contract has an economic purpose and that the contract is not susceptible to manipulation or otherwise contrary to the public interest. Moreover, the exchanges must bear the costs of inappropriate contract terms imposed on them by the CFTC. Finally, improvements in existing contracts may be delayed by the CFTC or never undertaken because of the regulatory costs involved.

III. The SEC and Proposed New Futures Contracts

A. A Critical Analysis of the SEC's Position

The SEC has objected to new proposed subindex contracts. The ostensible basis reason for this objection is lax regulation of commodities trading. In response to a proposed futures contract on Standard and Poors high technology index, for example, the SEC objected on the ground that the contract was readily susceptible to manipulation:

Although the index is capitalized at slightly more than \$193 billion and includes 41 stocks, IBM, with a capitalization of \$77 billion, represents almost 40 percent of the weighting of the index. At that level of concentration, a person attempting to engage in an intermarket manipulation involving futures on the High Tech Index might be able to focus almost entirely on manipulating the price of IBM and remain reasonably confident that the index would move in the desired direction. Given the leverage obtainable by the use of a futures contract, this index appears to be readily susceptible to manipulation.²⁸

The SEC has also expressed opposition to other subindex contracts because of their susceptibility to manipulation, which is due to thin

28. Letter from George Fitzsimmons, secretary, SEC, to David Horner, director, Division of Economics and Education, CFTC, p. 9.

capitalization ("the S & P Utility Index . . . is capitalized at \$79 billion, equal to just 5.1 percent of total New York Stock Exchange equity capitalization") or undue concentration within the index ("the five largest companies in the index account for 30.8 percent of the index capitalization").

Another related ostensible reason for opposition is the possibility that people with inside information would use the new subindex contracts. In commenting on a proposed energy index contract, the SEC stated:

The SEC is concerned that the Energy Index futures contract could have a significant disruptive effect on the securities markets. In particular, it is concerned about the potential use of the futures by persons wishing to avoid the prohibitions against trading on inside information contained in the federal securities laws. The SEC recognizes that the capitalization of the index (over \$204 billion as of September 30, 1983) is quite substantial. Nevertheless, the SEC believes that the fact that one stock constitutes more than 15 percent of the index raises the possibility that the index future could be used successfully to profit from inside information regarding that security.²⁹

As a result of its concerns regarding manipulation, insider trading, and other regulatory disparities, the SEC concluded that the new proposed contracts would be used as "surrogates" for equity investments and would "compete not on an economic basis but on the basis of regulatory differences between futures and securities markets."³⁰

It is possible to respond to these arguments on two different levels. The first level emphasizes their implausibility. The SEC assumes, for example, that it is a simple matter to manipulate the price of IBM. One might have thought that, short of a fraud committed by IBM itself, manipulation of the price of IBM would be virtually impossible. Probably no stock is more closely watched by investment analysts and other market professionals. If the notion that publicly traded securities are efficiently priced has any validity, and a massive and growing literature suggests that it does, the probability that IBM's price can be manipulated is close to zero. At the very least, the burden should be on the SEC to demonstrate how this manipulation could be accomplished.

The arguments concerning insider trading are similarly unpersuasive. First, it is unclear what is meant by insider trading (just as it is unclear what is meant by manipulation). Presumably, the SEC does not want to outlaw all informed trading because to do so would destroy the viability of futures markets. The concern must be narrowed: perhaps the SEC is concerned that insiders of a particular firm who are unable

29. *Ibid.*, p. 3.

30. *Ibid.*

under current SEC policy to trade in their firm's securities will trade index futures contracts. But what if they do? The rationale for the SEC's current "war" against insider trading is "unfairness" to stockholders and maintaining public confidence in securities markets.³¹ Neither of these concerns is implicated by trading in futures markets. In any event, insiders can profit on such information under current law by trading in securities of related firms to which they owe no fiduciary duty. Indeed, trading in correlated stocks appears to be a much more likely method of profiting on valuable information than does trading an index where 85% of the index's capitalization is composed of other securities.

A second level of response to the SEC is to question its implicit assumption of investor irrationality. The entire thrust of the SEC's arguments is that investors who trade futures contracts will be exploited because they will be deprived of the SEC's protections in the areas of manipulation, insider trading, and so forth. If this is true, however, there is no need for concern. The fear of exploitation will cause the contracts to fail, or, at worst, only the exploiters will trade and can then exploit each other.

Thus there is a fundamental inconsistency in the SEC's position that entry regulation is needed to prevent investors from trading futures contracts because of regulatory differences and the argument that investors who trade futures contracts will be victimized. If investors valued the benefits of SEC regulation, they would refuse to trade without them. Why not allow investors the opportunity to vote with their dollars?

Perhaps the SEC would respond that investors are not sufficiently informed to be able to realize how much they will be exploited without the SEC's protections. In this case, all the SEC need do is to tell them by, perhaps, making a public declaration of the evils of trading without SEC protections. After all, the SEC prides itself on being a disclosure agency. The purpose of disclosure is to allow investors to make informed decisions concerning which security to purchase. No reason exists why these same investors should be denied the opportunity to make informed decisions whether to trade futures contracts.

B. An Alternative Explanation for the SEC's Actions

The stated reasons for the SEC's objections to futures trading on public-interest grounds are so weak as to suggest that there may be other reasons for its concerns. In particular, it is useful to examine the explanatory power of the economic theory of regulation in relation to the jurisdictional battle between the CFTC and the SEC.

31. These rationales have been strongly criticized; see Carlton and Fischel (1983) and Easterbrook (1981).

The central premise of the economic theory of regulation is that regulation is determined by market forces in much the same manner as other goods.³² Interest groups demand regulation to advance their private interests. Politicians and regulators who hope to maximize votes, contributions, size of budgets and staffs, and so forth provide the supply of regulation. Any correspondence between the amount and type of regulation and "market failures" under this theory is pure coincidence. Regulation is just as or more likely to aggravate a market failure or to create a "regulatory failure" where no market failure existed.

The economic theory of regulation suggests a completely different explanation for jurisdictional squabbles over new futures contracts than what is suggested by the public debate. Simply stated, the jurisdictional dispute can be analyzed as a fight over who will obtain benefits created by the demand for new transactional services.

Options on stocks, financial futures, options on financial instruments, options on futures, and options and futures on subindices were all for the most part developed during the 1970s.³³ Trading in new futures contracts has caused an unprecedented increase in the volume of futures trading, and, obviously, the same is true for options.

Exchanges sell transactional services the profitability of which is dependent to a large extent on volume. Each exchange, therefore, wants to get as much of the benefit as possible from new transactional services. Industry representatives such as brokerage houses who also profit by selling transactions services have the same incentives. Similarly, regulators increase the size of their staffs, budgets, and prestige by gaining control over new contracts.

One method of capturing the benefits from new transactional services is to offer a superior product that fully informed consumers will demand. Another method is to use the power of the state to tax your competitors or exclude them altogether. The incentive to incur resources to obtain the cooperation of government is a function of how close a substitute your product is to that of your competitor. At the extreme, if both products are identical, a tax on your competitor will allow you to capture the entire market.

The hypothesis suggested by the above discussion is that the closer a product that is or could be offered on a commodity exchange is to one that is or could be offered on a securities exchange, the greater the incentive of the securities industry and its regulators is to spend resources in an attempt to use the power of government to discourage competition. The greater interest and involvement of the securities

32. For general statements of the economic theory of regulation, see Stigler (1971) and Peltzman (1976). For applications to particular industries, consult virtually any issue of the *Journal of Law and Economics*.

33. The history of trading in futures markets is developed in Carlton (1984).

industry and the SEC since 1974 in what products are offered on commodities exchanges can be explained, under this hypothesis, because the products that could be offered by exchanges not regulated by the SEC became increasingly close substitutes for products offered by the securities industry and exchanges and regulated by the SEC.

Thus neither the securities industry nor the SEC was too concerned about the commodities so long as commodities constituted soybeans, wheat, pork bellies, and so forth. But the situation changed in the 1970s. Futures and options contracts, while not identical, are close substitutes.³⁴ Both can be used to predict what the price of a given stock or commodity will be at a given time in the future. Both can be used to hedge or minimize risk.

The securities industry and its regulators have been quite successful in reducing competition from producers of substitute products. For example, options trading on individual stocks is flourishing, while futures trading on individual stocks is prohibited. Futures trading on subindices has not been prohibited, but the securities industry and its regulators have obtained the next best thing—a veto power. At the same time as the SEC has objected to futures contracts on subindices it has approved option contracts on a computer technology index, an oil and gas index, and an international oil index, although none of these contracts would have passed the test the SEC imposed on their futures counterparts.³⁵

Of course, the SEC would no doubt respond that the preferential treatment given to the securities industry is attributable to greater regulatory protections. This is specious, however, for the reasons stated above. If consumers valued SEC protections, they would not trade without them. The SEC's actions can be more readily characterized as the stifling of competition to the detriment of consumers than as an attempt to protect consumers from being exploited.

The above discussion is meant as suggestive rather than as a comprehensive theory of regulation of futures markets. A comprehensive theory would require empirical support for the proposition that futures and options contracts are substitutes (as opposed to complements). A comprehensive theory would also require an explanation for entry regulation in futures markets administered by the CFTC that predated SEC involvement. Nevertheless, I believe the hypothesis generated by the economic theory of regulation is a much more plausible starting point for understanding jurisdictional disputes than are the vacuous arguments that have dominated the public debate.

34. The relationship between futures and options contracts is discussed in Jaffee (1984).

35. See Edwards and Edwards 1984.

IV. Alternative Regulatory Schemes

A direct implication of the preceding discussion is that consumers are the victims, not the beneficiaries, of the current regulatory system whereby the SEC has effective veto power over new futures contracts. A further implication is that consumers would probably be best served by complete abolition of all entry regulation of futures contracts. Introduction of new futures products would then be similar to introduction of other types of products in the economy. Since complete abolition of entry regulation is unlikely in the near future, I consider in this last section several other possible regulatory schemes. They are, in descending order of desirability from the perspective of maximizing consumers' welfare, two agencies with neither having exclusive jurisdiction or a veto power, two agencies with each having exclusive jurisdiction but no veto power, and one merged agency.

The best alternative to no entry regulation would be competition in entry regulation.³⁶ This could be accomplished by having two agencies with jurisdiction over all futures and options contracts and allowing any exchange the opportunity to choose between them. If one agency took too long to approve contract or imposed overly onerous requirements, the exchange could simply go to the other agency. By introducing this competition between agencies, the regulatory tax that any one agency can impose is minimized.

A likely objection to this proposal is that competition in regulation will lead to a "race for the bottom" where exchanges will choose the least-regulated environment to the detriment of consumers. The argument is identical to the SEC's argument that consumers will trade futures contracts because of lax regulation, and so is the response. If consumers prefer more regulation, an exchange that chose to be under the jurisdiction of an agency that was too lax would lose business to other exchanges that were regulated to the level that consumers desired.

The next best alternative would be to retain the CFTC and the SEC but to eliminate the SEC's veto power. Because products under the jurisdiction of each agency are relatively close substitutes (i.e., options and futures on the same subindices), the effect of a regulatory tax imposed by either agency is blunted by the ability of consumers to choose. If the SEC raises the cost of trading by imposing more regulation than consumers demand, for example, consumers can shift to financial instruments under the jurisdiction of the CFTC, where the costs of trading are lower. Moreover, the potential that consumers will shift in this manner is itself a constraint on the SEC's behavior.

36. The regulation of the banking industry is an example of competition in regulation where banks can choose which agency and set of rules they want to be governed by; see Scott 1978.

The worst alternative from the perspective of consumers is a merger between the two agencies. A merger would eliminate competition between the agencies and thus limit the choices available to consumers. Hence the size of the regulatory tax would likely increase. The ability to raise the costs of trading would still be limited by the availability of substitutes such as forward markets, but these markets do not offer the same advantages as organized futures and options markets.³⁷

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37. Telser 1981.

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