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REGULATION OF FINANCIAL MARKETS: PRINCIPLES AND APPLICATION

Presiding: WILLIAM L. SILBER†

The Regulation of Financial and Other Futures Markets

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MY ASSIGNMENT IS TO speak about the regulation of financial futures markets, but in this respect the differences between financial futures and the traditional commodity futures are comparatively minor. Most of what I have to say, therefore, will apply to the regulation of futures markets in general. Towards the end of my remarks I shall say something about the problems that are particular to financial futures.

The Need for Regulation

The idea that futures markets need regulation at all may well appear surprising. Is not the Chicago wheat pit, with hundreds of traders actively participating in the determination of prices, the very epitome of perfect competition? And would this not be even more true of such financial markets as the one in Treasury bonds, which has overtaken the older markets in volume and open interest? Regulation, most economists would feel intuitively, can only detract from the performance of perfectly competitive markets.

Actually, the paradox is not hard to resolve. Perfect competition is not self-sustaining: if left entirely to themselves, the traders in the pit would find it to their advantage—certainly in the short run—to form coalitions with a view to exercising market power. No less an authority than Adam Smith warned us about the conspiracies against the public that would result if businessmen got together without rules to preserve competition. The antitrust laws also derive their economic justification from the inherent vulnerability of competition.¹

From their earliest days on, futures markets have been subject to rules and regulations. In the beginning the rules were no more than the bylaws of the exchanges that served as the trading place. The initial regulation was exercised by committees of exchange members that were charged with interpreting and

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¹ In the discussion Professor Franklin Edwards raised the question why it is so important that futures markets be competitive. My answer refers to the economic functions of futures markets, the most important of which are price discovery and the facilitation of hedging. Clearly the performance of these functions is likely to be better the more efficient the market is. The relation between competition and efficiency is discussed below.

enforcing these rules. This so-called self-regulation is still of great importance today, and there will be occasion to come back to it. It is also clear, however, that self-regulation by exchanges cannot be the complete answer, no matter how competitive the activity on their trading floors. The exchanges themselves are monopolistic institutions, which restrict membership and deny floor access to non-members. The merchants and other traders who are in charge of self-regulation may be persons of integrity, but in the final analysis their responsibility is towards their fellow members, not towards the public at large.

Government Regulation

Consequently, self-regulation by exchanges in due course came to be supplemented by government regulation. Much of this was initially done through the courts, but from the 1920's on, the Federal Government also established regulatory bodies, such as the Grain Futures Administration. In the United States most of the pressure for this intervention came from farmers, who have traditionally viewed futures trading with suspicion, if not outright hostility. The phenomenon of short selling, greatly facilitated by the development of futures contracts, has always looked especially sinister to the unsophisticated; a misunderstanding of short selling is at the basis of the longstanding complaint that futures trading tends to depress prices received by farmers for their products.

For many years government regulation of futures trading was confined to agricultural commodities, and these commodities were in fact the principal objects of futures trading in this country. In 1936, the already existing activities of the Federal Government in this area were consolidated in the Commodity Exchange Authority, a division of the U. S. Department of Agriculture. Nonagricultural commodities remained free of federal regulation. In fact the Commodity Exchange Authority did not even regulate all agricultural futures trading, since legislation was needed to bring new contracts within its purview. Usually the Commodity Exchange Act was amended only after a new contract had become established, so that the CEA had little or no influence over the early development of new contracts.

To its credit, the Commodity Exchange Authority did not regulate the agricultural futures markets with a heavy hand. Much of its activity was statistical: it published detailed reports on open interest, volume of trading and prices that were not only useful to traders and other interested parties, but also facilitated academic research. Its principal responsibility, however, was the prevention of corners and squeezes, a subject to which I will return. In addition the Commodity Exchange Authority licensed contract markets and various types of brokers and traders.

During the 1960's the scope of futures trading expanded significantly. First came futures in livestock and livestock products, then came silver futures, followed later by gold and other precious metals. Contracts in lumber and plywood were another innovation. Perhaps the most important breakthrough was the extension of futures trading into the financial sector, which started with the successful introduction of currency futures in 1972. These were followed a few years later by interest rate futures; those in bonds and bills were particularly

successful. At the same time some old-established contracts, such as those in wool and eggs, faded from the scene. The net result was a tremendous expansion in the volume of futures trading.

Since most of this expansion was in the nonagricultural sector, the Commodity Exchange Authority with its specialization in domestic agricultural markets covered a smaller and smaller fraction of the field. Moreover, several exchanges (particularly the Chicago Board of Trade and the Chicago Mercantile Exchange) that until recently traded only futures in farm products went heavily into the new contracts. Increased concern for consumer protection focused attention not only on the new futures contracts, but also at public participation in commodity options and other instruments, which were not subject to any kind of regulation.

All these considerations led to a comprehensive revision of the regulation of futures trading. In 1975 the Commodity Exchange Authority was replaced by a body similar in structure to the existing regulatory commissions, the Commodity Futures Trading Commission. The new agency was given supervision over all futures trading, regardless of object, and also over commodity options. While retaining the regulatory powers of the Commodity Exchange Authority, it was charged in addition with approving new futures contracts. With its enlarged powers and a sizeable staff, the five-member commission has been in a position to play a more visible role in the industry than its predecessor had ever attempted. The CFTC has put more emphasis on enforcement and less on statistics than the CEA; in fact its statistical program is quite limited and does not include anything as useful as the annual *Commodity Futures Statistics*, now discontinued.

Preserving Competition

After this brief historical review let us now turn to the principal issues in the regulation of futures markets, without trying to be comprehensive. As mentioned earlier, the main problem is to make these markets as competitive, and as efficient, as they can be. The distinction between a competitive and an efficient market may be considered academic, but is nevertheless worth bearing in mind. A competitive market is one where no single trader, or group of collaborating traders, can affect the price more than momentarily. An efficient market is one that processes all relevant information promptly. Actually, since the relevant information is held by at least some of the traders, the crucial precondition to efficiency is that everybody can trade, thus transmitting the information to the process of price determination. But easy access to trading (called "entry" in the literature on industrial organization) is also a characteristic of competitive markets. Therefore what matters in practice is competition; if that is assured, efficiency is bound to follow.²

The most serious danger to competition is the exercise of market power by individuals or groups of traders. In futures markets this danger is most likely to arise when a contract approaches maturity because outsiders generally avoid delivery. Open positions in an expiring future therefore tend to be more highly

² Problems of efficiency may nevertheless arise if traders, no matter how numerous, are strongly influenced in their trading decisions by factors internal to the market (such as "market action") rather than by external information (fundamentals).

concentrated than in a future that is several weeks or months away from maturity. If the concentration becomes excessive (particularly on the long side of the market) there may be a "squeeze" or a "corner."³ Most of the regulation of futures trading is aimed at preventing corners and squeezes; in other words, at promoting the "orderly liquidation" of expiring futures contracts.

While corners, and to a lesser extent squeezes, have long been unlawful in themselves, legal sanctions have proved to be insufficient to prevent them altogether. The difficulty is that entry into the cash market, which is composed of professionals, is naturally much harder than access to the futures market. Even where there are many cash operators only a few may be interested in deliveries in a particular maturity, since the grades and locations may not appeal to them.⁴ Thus there can be "natural" squeezes.

The prevention of undue concentration in expiring contracts requires knowledge concerning the distribution of the open interest long ahead of maturity. Such knowledge is available to the clearing house but cannot normally be divulged by it. For many years government regulators have been empowered to obtain daily reports from large futures traders. From these reports concentration ratios (separately for longs and shorts) can be calculated, and they are also used for the enforcement of "position limits" applicable mostly to speculators in agricultural markets. Whether position limits make economic sense, and if so to whom they should apply, is one of the most controversial issues in futures regulation.

At present position limits are expressed in absolute amounts (for instance, x million bushels of wheat). These limits may not be very restrictive in expiring contracts, where the total open interest is normally low. On the other hand they may be unduly restrictive in contracts that are not close to expiration: traders with strong views on price prospects may be prevented from buying or selling additional contracts when they consider it appropriate; thus reducing the efficiency of the market. An alternative would be to express the limits not as an absolute amount but as a percentage of the open interest on some benchmark date, with the benchmark moving from month to month. Such a scheme would force the largest traders to liquidate their positions as the total open interest declines toward expirations. Forced liquidation, however, is naturally resisted by large traders.⁵

There can be no doubt that position limits, unless they are so large as to be

³ These concepts are usually distinguished according to the situation in the cash market. In a corner the longs in the futures markets also control the cash market; in a squeeze they do not, though of course a successful squeeze is only possible if the cash market is tight.

⁴ The limited interest in delivery on the part of commercials is the result of "sellers' option," an asymmetric feature of futures contracts that was originally introduced to make manipulation at maturity more difficult. If cash settlement were feasible, the problems described here could not arise. At present one futures contract with cash settlement has just started trading (the Eurodollar contract on the International Monetary Market in Chicago) but it is too early to say whether it is viable. For a detailed discussion of cash settlement see CFTC, *Report to the Congress in Response to Section 21 of the Commodity Exchange Act* (May 29, 1981), Part Three, pp. 117-127.

⁵ At present exchanges can use their emergency powers to force liquidation, regardless of position limits, if the open interest in a contract fails to decline according to normal patterns. A less drastic measure is to allow trading for liquidation only (i.e., no new positions).

irrelevant, can interfere with the efficient operation of a futures market. The question is whether such interference is a greater evil than excessive concentration. This is basically an empirical question on which research is badly needed. The CFTC has proposed the extension of position limits to all markets, but it has not yet produced much supporting evidence.⁶ Research would probably bolster the case for position limits, but it could also produce a better formula than the one currently in force for agricultural futures.

A related issue is whether limits should apply only to speculative positions or also to hedge positions, which are presently exempt. This issue is especially relevant to long hedgers (those who are long in futures and short in the cash market). The regulatory definition of long hedging, unlike that of short hedging, is rather flexible since a short cash position may consist of little more than an intention to sell that need not be laid down in a forward contract. There may have been reasons for exempting this so-called anticipatory hedging from position limits,⁷ but the effect has been to open a large loophole in the speculative limits. If position limits are to be applied more generally the exemption of anticipatory hedges should also be reconsidered.

A different loophole consists of trading by foreign entities, possibly with American participation. The major American exchanges serve a truly worldwide function and much of their business originates abroad. The resulting cosmopolitan character is appropriate and desirable from an economic point of view. However, it also creates regulatory problems since the CFTC and the courts cannot easily enforce U.S. laws and regulations beyond our borders. This is one of several areas where the extraterritorial application of national laws creates a potential for diplomatic friction.

An extreme solution would be simply to exclude from U.S. markets those foreign traders who are unwilling to abide by U.S. rules (including reporting), but this might drive valuable business to foreign markets with more lenient rules. The difficulty is compounded when foreign traders are government-controlled or semi-official organizations; thus it has been alleged that Latin American groups have used the New York market to stabilize (or perhaps drive up) the price of coffee. There are advantages in using futures markets rather than cash markets for commodity stabilization schemes,⁸ but it would be hard to reconcile with current regulatory philosophy in the U.S. The international aspects of futures regulation are in need of further study.

⁶ The immediate occasion for this proposal was the 1979–80 disturbance in the silver market, on which see Part Two of the previously cited CFTC *Report to the Congress*. The Commission argues correctly that “Reasonable limits on speculative futures positions (. . .) would have helped prevent the accumulations of such large positions [as those of the Hunt brothers and others] and the resultant dislocations created when the holders of those positions stood for delivery.” (p. 173). However, the Commission does not say anything about possible adverse effects of position limits on market efficiency.

⁷ This may well be the reason why in some markets, such as corn, the reported long hedging position frequently exceeds the reported short hedging position, contrary to the normal pattern in futures markets.

⁸ See H. S. Houthakker, *Economic Policy for the Farm Sector*, American Enterprise Institute, Washington, D.C. 1967, Ch. 4.

Volatility and Solvency

Futures prices are notoriously volatile, at least in the short run. Participation in futures trading is therefore risky to the point where bankruptcy—and hence default on contracts—is an ever-present possibility. Yet the standardization that is of the essence in futures contracts⁹ requires, among other things, impersonality. The trading by open outcry that is characteristic of American-style exchanges presupposes that traders do not have to worry about the solvency of their counterparts. The necessary assurance is provided by the intercession of Clearing Houses, which act as buyer to all sellers and as seller to all buyers.

How can Clearing Houses in effect guarantee the fulfillment of open contracts? They can do so, in large part, because they demand margin deposits from their members, who in turn demand them from their customers.¹⁰ So-called variation margins are collected (and disbursed) every day before the market opens, in accordance with the previous day's price movements.

This necessary practice has important consequences for the pricing process. If daily price changes were unlimited the variation margins would also be unlimited and it would be more difficult to collect them. To facilitate collection, exchanges have long had daily price limits, for instance 60 basic points in Treasury bills. These daily limits, which not infrequently bring trading to a virtual halt, are probably the most serious departure from theoretical perfection in the futures markets. If the daily limits are narrow they may be effective for several days in a row, during which time the futures market—except possibly for the spot month, if it is exempt from price limits—cannot perform its vital function of price discovery.

The size of the daily price limits is related to the size of the initial margins required on newly opened positions. If these margins are small, so will be the price limits.¹¹ Small initial margins, however, are strongly supported by the exchanges because they are believed to encourage speculation by outsiders. There is at present no government regulation of margin requirements, though it has often been proposed.¹² Should there be regulation?

On balance regulation of margins and daily limits can probably not be left entirely to the exchanges. While it may be true that low initial margins entice more members of the public into the markets and thus increase liquidity, this is not an unmixed blessing since many of the new entrants probably lack the financial stamina on which socially useful speculation depends. A high incidence of "limit days" on a futures market may be considered *prima facie* evidence that its daily limits are unduly low; in that case its initial margins would also bear investigation. It would not be desirable for the CFTC, which has been very

⁹ Futures contracts are defined along these lines in H. S. Houthakker, "The Extension of Futures Trading to the Financial Sector" (forthcoming in the proceedings of a 1981 symposium at Northwestern University).

¹⁰ For a somewhat different view of margins see Lester G. Telser, "Margins and Futures Contracts," *Journal of Futures Markets*, Vol. I, No. 2 (Summer 1981).

¹¹ These statements reflect casual observation, not systematic research; they need to be verified empirically.

¹² Most recently by James M. Stone, former Chairman of the CFTC, in his "Additional Comments on the Interagency Study of the Silver Markets," *CFTC* (June, 1981).

responsive to political pressures, to set limits or margins. Nevertheless the Commission should probably have the power to require exchanges to justify their daily price limits and initial margins in the light of experience, and to overrule the exchange in carefully defined circumstances. In doing so the CFTC should have to consider the need both to preserve market liquidity by adequate public participation, and to preserve market efficiency by continuity of price quotations. It would, incidentally, also be an improvement if price limits and initial margins were set by the exchanges (and their Clearing Houses) at a percentage of the previous day's price rather than at a fixed money amount, as is presently done. This change would eliminate the need for frequent revisions of price limits and margins. I understand that a procedure that goes in the same direction has been adopted by the Commodity Exchange in New York.

New Contracts

There is probably no area where the establishment of the CFTC has made more difference than in the introduction of new futures contracts. All new contracts have to be approved by the Commission, a process that has led to lengthy delays because it involves a public notice in the *Federal Register* and considerable discussion between the exchanges and the Commission's staff. More seriously, perhaps, is the resulting loss of priority to the exchange that first designs a new contract only to find other exchanges ready to duplicate it. While duplication is not necessarily undesirable, some of the incentive for designing new contracts is lost in the process.

The CFTC is charged by law with making sure that contracts satisfy an economic purpose. Is this requirement necessary? Exchanges, after all, will not engage in the laborious and costly design of a new contract unless they expect it to be successful (that is, to lead to a large volume of trading). The history of commodity exchanges is full of new contracts that failed to attract traders, so that the investment in designing them was lost.¹³ Experience to date hardly suggests that the Commission has an advantage over the exchanges in predicting which new contracts will survive, or that its approval makes these contracts more viable. The test of survival is essentially a market test to whose economic validity the CFTC can contribute little or nothing.¹⁴ It follows that the Commission's examination of new contracts should be drastically curtailed.

Off-exchange Contracts

Another area in which the CFTC has been active is the suppression of commodity contracts that are not traded on designated boards of trade. Such contracts have been offered by many firms under a variety of names, including

¹³ See the valuable paper by William L. Silber, "Innovation, Competition, and New Contract Design in Futures Markets," *Journal of Futures Markets*, Vol. I, No. 2 (Summer 1981), with comments by Gary L. Seevers and James K. Dew.

¹⁴ The only possible contribution—a political one—is identified by Seevers in his comment on Silber's paper. Seevers argues that CFTC approval "protect[s] futures markets from the political process," which in the past has led to the prohibition of futures trading in onions and could lead to similar mischief in the future. This is a sad comment on the political process, but a realistic one.

options and leverage contracts. To the extent these contracts are fraudulent, as quite a few of them were, there is much to be said for being tough. The CFTC can be useful in the prosecution of criminal cases by contributing its knowledge of commodity markets to the District Attorneys and judges on whom the main litigative burden rests.

It is fair to say, however, that the Commission and its staff have been equally zealous with respect to off-exchange instruments where no allegations of fraud could be made. Here the economic rationale is less clear. One cannot help recalling that old-line regulatory bodies such as the Interstate Commerce Commission tended to become captives of the industries they were supposed to regulate. The CFTC regulates the commodity exchanges, an industry with few firms and a somewhat oligopolistic structure not unlike that of other regulated industries. Can its campaign against off-exchange instruments be interpreted in the same terms as the ICC's efforts (except for a brief period of deregulation) to suppress competition in transportation?

Probably not. The CFTC's relations with the exchanges do not appear to be close enough to warrant comparison with the ICC in the bad old—and possibly bad new—days. The explanation for the CFTC's attempts to confine commodity trading to exchange floors is probably strictly bureaucratic. The surveillance and enforcement mechanisms it inherited from the Commodity Exchange Authority are geared to the exchanges, not to independent operators. From an administrative point of view these independents are simply a nuisance. Thus the CFTC fought hard against so-called dealer options in commodities, as opposed to exchange-traded options for which it has long had its own pilot program. The Commission lost that fight; dealer options have been traded—uneventfully, it seems—for some years, thus providing useful experience for the eventual introduction of commodity options on the exchanges.¹⁵

The CFTC has also tried to stop trading in so-called leverage contracts. These may be viewed as the retail equivalent of futures contracts, which are essentially of a wholesale nature. Of the several differences between leverage contracts and futures contracts, the most important one is probably that the former are entered into bilaterally with a single firm, rather than multilaterally with a Clearing House. The resulting lack of impersonality makes leverage contracts unsuitable for hedging and price discovery, the main functions of futures; they also do not lend themselves to trading by open outcry. On the other hand leverage contracts, offered mostly in precious metals and coins, may be more interesting to individuals, for instance, if they want to convert them into physicals without going through the complexities of futures delivery. Leverage contracts can also be of smaller size than the standard futures contract. They would seem to have a modest but useful place in the spectrum of financial instruments. The firms that offer leverage contracts and dealer options should not be exempt from ordinary reporting requirements, but neither should they be put out of business merely for

¹⁵ Perhaps the main lesson to be drawn from this episode is that the CFTC should not have insisted on the close supervision of the exchange-traded options program that has so far prevented its implementation. Any abuses that might have surfaced on the exchanges could have been dealt with under its existing authority.

bureaucratic convenience. Here, too, the market should be the ultimate arbiter.¹⁶

The effectiveness of the CFTC's actions against off-exchange trading has been impaired by a curious (and apparently deliberate) omission on its part: it has never officially defined a futures contract. Its position that leverage contracts are really futures contracts in disguise is consequently open to the charge of arbitrariness. This legal point is now before the courts. As an economist who has attempted a definition,¹⁷ I can only express the hope that the Commission will come up with a valid definition that recognizes commercial reality.

Clearing Houses

An area in which the CFTC has had very little involvement but which deserves greater attention is the prospective solvency of Clearing Houses in extreme conditions. Clearing Houses, of course, occupy a vital place in futures trading because they in effect guarantee the execution of all open contracts. Originally they were able to make this guarantee credible because the individual members (in those days invariably partnerships or sole proprietorships) had to permit a prior claim by the Clearing House on virtually all their business and personal assets. The more recent admission of corporations, whose shareholders have no individual liability, did not reduce the credibility of the Clearing Houses appreciably because these corporations were often large firms with considerable assets outside of their futures activities. The Clearing Houses remained "good to the last drop."

The present situation is not quite as reassuring. The silver crisis of 1979-80 did not lead to any immediate difficulties for the Clearing Houses, but it did make their members aware of their potentially fatal exposure in case of a default by a major trader in futures. The reaction of several firms, especially the larger ones, was to set up separate commodity subsidiaries to whom the Clearing House memberships were transferred. These subsidiaries typically specialize in futures trading and at most have a limited claim on the parent companies' assets.

It is not at all clear whether the Clearing House guarantees have in fact been weakened by these developments, which must be viewed against a background of greatly expanded open interest in futures. However, the matter is important enough to be looked into more closely by an outside body such as the CFTC. A default by a major Clearing House could have a devastating effect on our entire financial system.¹⁸ Indeed any doubts about the solvency of a Clearing House would have a chilling impact on futures trading generally. The considerable overlap that exists in the membership of different Clearing Houses would make it difficult to isolate the problems of any one of them.

¹⁶ It could be argued that retail instruments divert volume from the exchange floors and thereby reduce liquidity. However, the dealers who offer these instruments will have to cover a large part of their positions in futures and this creates volume on the traditional markets. Moreover some of the retail business would probably never go into futures anyway.

¹⁷ See the reference given in fn. 9 above.

¹⁸ Although the silver crisis did not reach this point, it came uncomfortably close to spilling over into the stock market. (see part I, p. 148-49 of the CFTC's *Report to the Congress*, 1981)

Special Problems of Financial Futures

As stated at the outset, financial futures are like other futures in most respects, including regulation. There is really only one difference and it is merely a difference of degree: financial futures are more important from a policy point of view. This is especially true of interest-rate futures, which are very responsive to monetary and fiscal policy. It would also be true of futures in foreign currencies were it not for the relatively minor share of foreign exchange trading that futures have achieved to date.

Does the connection between government policy and interest-rate futures call for special rules or supervision? For instance, should government agencies worry if (as has often happened in recent years) futures prices on Treasury securities imply quite different interest rates than the monetary and/or fiscal authorities have in mind? The answer is clearly in the negative. Such discrepancies may be embarrassing to the authorities, but they are inevitable and proper in a free, market-oriented economy. The markets merely register the opinions of the private sector, and futures markets do so more accurately and more comprehensively than spot markets.

There is a legitimate question whether government agencies should ever participate *as traders* in these markets.¹⁹ Whatever one thinks of this, the question is not one about regulation.

A different, and less important, question involving the government is whether the Treasury has any responsibility for the deliverable supply in the relevant futures markets. This is hardly a problem at the moment when the budget deficit is large and the Treasury has to offer new issues all the time. Conceivably, this will not always be the case, and there might be a limited inventory of (say) Treasury bills deliverable on an expiring contract. If so, the answer is to be found in extending the range of deliverable securities.

Conclusion

By way of a summary I shall simply restate the principal implications for CFTC policy from the preceding analysis:

1. Self-regulation by exchanges, while continuing to be important, needs to be supplemented by carefully chosen government regulation.
2. The CFTC should expand its statistical program at least to the level maintained by its predecessor.
3. Position limits, preferably extended to long hedgers, are a necessary instrument for preventing undue concentration; they should be expressed as percentages of the open interest rather than as absolute amounts.
4. There is a case for limited surveillance by the CFTC of daily price limits and initial margins, but they should continue to be the main responsibility of the exchanges and Clearing Houses.
5. CFTC involvement in the design of new contracts is of questionable usefulness and should be drastically curtailed.

¹⁹ It may be recalled that Keynes favored government intervention in the forward exchange market. See also fn. 8 above.

6. The Commission should continue to assist law-enforcement authorities in the detection and prosecution of commodity fraud, but it should be more open-minded about non-fraudulent off-exchange instruments. In this connection it should define futures contracts.
7. The CFTC should study recent developments in Clearing Houses with a view to ensuring their solvency in extreme situations.
8. There is no need for special rules on supervision concerning financial futures.