
Stock-Index Futures: Don't Tinker With Success!

BY KENNETH D. ACKERMAN

Just 221 months ago, stock-index futures and options did not even exist. Yet already, stock-index products (futures/options/options on futures) are among the most commercially successful new trading instruments to emerge on U.S. exchanges in a decade. As of October 26, 1983, open interest on the three major domestic stock-index futures markets totalled 43,893 contracts, representing a cash equivalent of \$3.293 billion. That same day, the three most active stock index options traded a combined 445,766 puts and calls.

This large trading volume translates into rich fees and commissions for exchanges, brokerage houses, and "market professionals" alike, and the huge commercial demand for stock-index products has spawned a vigorous competition between two industries—securities and futures—each trying to incorporate these markets into their plans for financial success through the 1980s. [See Table A.]

But the contest has also touched sensitive nerves in the federal regulatory system, possibly clouding the very regulatory environment that gave rise to the new markets.

Stock-index instruments are a direct offspring of regulatory reform. It

was only after the two federal government agencies directly concerned with financial trading—the Commodity Futures Trading Commission (CFTC) and the Securities and Exchange Commission (SEC)—agreed in December 1981 to settle their prior seven year jurisdictional tug-of-war that the CFTC designated the first stock-index futures and the SEC approved the first stock index options for trading on American exchanges.

The fact that futures and options are regulated by two different federal commissions—the CFTC and SEC respectively—with two differing regulatory systems, has caused some to cry foul. The Chicago Board Options Exchange (CBOE), for instance, has suggested that this bifurcated system creates "unwarranted competitive advantages and disadvantages" between the two products, a "regulatory disparity" totally divorced from the quality of the goods themselves.

As a result, substantial new legal and institutional adjustments are now being urged which, taken together, could amount to a substantial overreaction seriously hampering the vigorous new stock index markets.

SEC Chairman John S.R. Shad, for instance, has proposed that SEC and CFTC regulation of their respective stock index products be conformed by—

these contracts;

- Creating a new joint SEC/CFTC/Federal Reserve Board panel to oversee margins for both stock and futures exchanges; and
- Sharing Commission members between the SEC and CFTC so that both agencies would produce similar policies.

SEC Commissioners Barbara Thomas and Bevis Longstreth have gone further, both proposing total or partial merger of the CFTC into the SEC, a view also shared by the CBOE. The New York Stock Exchange (NYSE) and the Securities Industry Association (SIA), while opposing an SEC/CFTC merger, have particularly urged reform of margin-setting on securities.

This debate was sharpened earlier this year by the creation of a special Task Group on Regulation of Financial Services chaired by Vice President George Bush and co-chaired by Treasury Secretary Donald Regan. The mandate of the task group is to consider proposals for reform throughout the federal financial service establishment, primarily banking, but also including the futures/securities "disparity" issue. Meanwhile, the Federal Reserve Board, with staff cooperation by the SEC and the CFTC, has begun a review of margin setting for both futures and securities, including possible changes in its 50-year-old securities margin regulation system.

The origins of the conflict between securities and futures regulators go back over 60 years to the beginning of

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- Harmonizing SEC/CFTC rules where possible (a process already underway by the two agencies) and adopting a legislated policy of "equivalent regulation" for

U.S. regulation of financial trading. Traditionally, the SEC regulates securities, while the CFTC governs all futures trading. This division of federal responsibility between the CFTC and the SEC is no bureaucratic accident, but rather reflects differences between the underlying futures and securities industries dating back to their origins in the eighteenth and nineteenth centuries, and the very different economic environments, practices, and trading cultures that have evolved around each. SEC authority for options trading was not clarified by Congress until its 1982 codification of the CFTC/SEC jurisdictional reforms.

While historically the division between securities and futures was at least partly demographic—futures were mostly centered in Chicago, and their wheat, cattle, and sorghum markets held little appeal to New York City securities brokers whose business was stocks, bonds, and debentures—more important was a major gulf in the economic personae of the two industries, making joint regulation both a practical and theoretical mismatch.

Futures contracts, regardless of whether based on pork bellies, gold, U.S. Treasury bonds, or Swiss francs, are primarily risk management instruments, and not primarily vehicles for purchasing the goods themselves. Only rarely (less than 5 per cent of contracts) will a futures trader deliver or receive the commodity underlying the contract. Rather, futures provide an opportunity to participate in the interim changes in a commodity's price, separate and apart from possessing the physical goods themselves.

This is very different from stock trading, where the economic result of a transaction is trader ownership or non-ownership of shares of stock, and the regulatory policy goal, beyond investor protection, is to aid national capital formation.

Options on individual stock issues differ from both stocks and futures. As with futures, options allow holders to participate in price changes separate from ownership of the underlying stocks themselves. The buyer of a call

option on IBM stock might never actually exercise the option and buy the IBM stock, but his option will still produce profits and losses as the stock price moves. But as with stocks, the regulatory goal is to maintain efficient corporate financing and contribute to capital formation.

In 1981, the securities options markets, which until then only traded options based on single stocks, received clearance from the SEC to broaden their offerings by trading options on U.S. Treasury securities and GNMA certificates—items traded under futures contracts since 1975.

For securities exchanges, these "new generation" options represented an important competitive opportunity vis-a-vis their futures counterparts. For over a decade, U.S. futures exchanges have enjoyed a phenomenal wave of growth as total annual trading volume boomed from 13.6 million contracts in 1970 to 112.4 million in 1982. Beginning in the late 1970s, this growth was based largely on the popularity of financial-based futures contracts. With their new financial options, securities exchanges hoped to offer a direct competitive alternative to the financial futures and possibly attract some of this growing business to their own trading floors.

The biggest potential bonanza was offered by stock-indices. In a typical week, nearly 300 million shares of stock change hands on the New York Stock Exchange—a total of 16.46 billion shares in 1982. At the close of 1980, a full 33 per cent of the \$1.57 trillion worth of outstanding U.S. stock was held by institutional investors representing some of the country's key social and financial institutions: private pension funds, foundations, educational endowments, insurance companies, and state/local retirement funds.

Yet, with vast portions of America's wealth tied to the stock market, stock prices can be mercurial. Between August 1982 and June 1983, for instance, the Dow Jones Industrial Average rose from 776 to 1,245, an increase of over 60 per cent in six months. A simple reversal of this trend could

cause substantial losses for large commercial stock holders. Stock-index instruments offer "price insurance" against just this type of risk.

The extent to which stock-index products have established themselves goes far beyond just initial trading volume statistics. Futures or options contracts based on such indices as the Standard & Poor's 500 and 100, the New York Stock Exchange Composite, the Value Line Composite, and the American Stock Exchange's Market Value and Major Market figures, are all actively traded today. At the same time, the securities and futures exchanges themselves have initiated a series of cooperative experimental links. For instance, in early May, the Chicago Board Options Exchange and the Chicago Mercantile Exchange agreed to share their popular index contracts, allowing CBOE to now offer an S&P 500 *option* paralleling the CME's S&P 500 *futures* contract and, conversely, allowing CME to offer an S&P 100 *future* paralleling CBOE's CBOE 100 *option*, which was renamed the "S&P 100." A similar arrangement has been reached between Amex and the Chicago Board of Trade, while the New York Stock Exchange shares a trading floor for stock-index products with its subsidiary, the New York Futures Exchange.

Most recently, the inter-industry competition has spawned even more specialized index contracts. Securities exchanges, for instance, have now begun trading "narrowly based" index options based on stocks drawn from particular industry groupings like technology or energy. Futures exchanges, meanwhile, have applied for CFTC approval of contracts based on the Consumer Price index, and indices of housing starts, auto sales, corporate profits, commodity prices, and other economic indicators, as well as more broadly based sectoral stock indices.

The most frequent allegation of "regulatory disparity" between securities and futures involves margins. Since margins determine the entry cost of the investment to a customer, lower margins for one instrument

would make it cheaper for customers to establish a position in that instrument than in its competitor's market, and therefore, presumably create an unfair competitive advantage.

In 1934, Congress empowered the Federal Reserve Board to set margins for all regulated American securities trading—a "reform" growing from the 1929 stock market crash aimed at controlling speculative credit. "Margin" in stock trading, currently set at 50 per cent, is the amount of cash that a customer must actually present in order to purchase stock. The remainder of the stock's purchase price is financed by a direct loan from the broker or a bank to the customer—an extension of credit under Federal Reserve Board rules.

In futures trading, however, "margins" play a totally different role. Since traders of gold futures contracts, for instance, do not actually buy the gold itself, but only enter commitments to purchase or deliver gold at some future date, the margin payment is a good faith deposit on ultimate contract performance; no credit is extended. Rather, futures margins are designed solely to ensure market integrity. Margins are set at levels expected to cover a customer's potential losses in any anticipated short-term price swing, and those losses or gains are "marked-to-the-market" each day.

As a result, margins for futures are set by the futures exchanges themselves, with CFTC intervention allowed only during market emergencies. Also, futures margins are generally much lower than stock margins as a percentage of contract face value—presently about 7 per cent for stock index futures—reflecting short-term market exposure rather than any credit commitment.

Stock-index options, however, being different from both stocks, futures, and traditional options on individual stocks, created special problems for the established securities approach to margin setting, and the SEC's and Federal Reserve Board's treatment of these instruments has required major breaks from past prac-

tice.

After soliciting public comments, the Federal Reserve Board decided that margins on stock-index and other post-Accord options would best be set by the exchanges themselves, as in futures. Unlike futures, however, the SEC must still approve each exchange-set margin before it takes effect. No such CFTC pre-clearance of margins on futures contracts is currently required, except regarding margining systems (not generally specific margin levels) for options on futures and options on physicals. Nevertheless, discussions with federal officials have preceded margin setting on each new stock-index futures contract.

As a result, margin-setting mechanisms for stock index options, stock index futures, and options on stock index futures are all strikingly similar—a fact reflected in the actual competitive parity of the options and futures instruments themselves.

Complicating the mix even further are claims by futures exchanges that

ers of this new government body have not been specified precisely, it presumably would be able to veto exchange-set margin levels.

Two possibilities are raised by this approach, depending on how a final proposal would be drafted. If the new federal panel is to wield significant powers to second guess exchange self-regulators, then the danger of inefficient government over-regulation arises. On the other hand, if the new panel is to remain a weak overseer of exchange decisions, then little is accomplished. In either case, the result appears to be a step backward from the status quo.

If inconsistent margin levels between futures and options create competitive advantages or disadvantages one way or the other, the nuances are subtle, and, so far at least, the investing public seems little concerned. After all, it is the S&P 100 option, operating under allegedly-oppressive SEC-approved margins, that has set all the commercial sales records, while the S&P 500 and other future-options

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they, too, suffer competitive disadvantages because securities options margin rules, in effect, do not require market-makers to deposit full premium payments for option purchases with their clearing-house margin accounts as futures rules for floor traders do, thereby creating an uneven financial burden for futures.

The specific proposal put before the Bush Task Group by SEC Chairman Shad would create a new tripartite federal panel composed of the SEC, the CFTC, and the Federal Reserve Board. While initial margin setting on all exchanges, futures and securities, would be performed by the exchanges themselves, ultimate oversight authority would rest with the new tripartite federal panel. While the precise pow-

are relatively weak market performers. Clearly, traders are basing their decisions on other factors.

Differences obviously do exist between SEC and CFTC regulations and, in some cases, these have created burdens for both industries. Particularly now that the traditional boundaries between securities and futures have blurred, many more traders today are participating in both marketplaces and find themselves subject to regulation by both Commissions. Of the more than 400 brokerage firms registered with the CFTC as futures commission merchants, for instance, perhaps a third are also registered with the SEC as securities "broker-dealers," either directly or through an affiliate or subsidiary.

Since the 1981 Accord, the CFTC and SEC have recognized this problem and have taken several steps to harmonize their regulations to minimize avoidable burdens on the traders who frequent both markets, including more uniform reporting and minimum financial standards. Last May, the two agencies jointly sought industry suggestions on how best to proceed.

But the proposals now being raised by some securities industry sources go beyond simple regulatory refinements and tinker with fundamental federal policies toward industry growth.

Calls for an abstract "regulatory equivalence" between futures and se-

curities sidestep the question of "equivalent to what?" Should futures be treated more like stocks, or securities more like futures? If the concern is that one industry is regulated "too much," can the proper solution ever be to spread the over-regulation around? Similarly, simply merging the CFTC into the SEC, or vice versa, says little about what kinds of rules the new combined agency would or should administer.

While the new post-Accord options may be similar to futures in both their economic function and structure, these similarities have been recognized by the free marketplace itself,

which is forcing adjustments in the rules governing both industries and is pressing the SEC and CFTC to develop a workable regulatory middle ground. As a result, if there was a "regulatory disparity" between traditional futures and stocks, this gap has narrowed quickly and effectively for stock-index products.

So long as the SEC and the CFTC are successful in implementing Congress' mandate under the 1981 Jurisdictional Accord, any notion of fundamental regulatory policy change will first need to address the preliminary admonition—"If it isn't broken, don't fix it!" □

Where the Competition stands:

Active stock index markets *

Futures (regulated by CFTC)

- Value Line Composite Index Future
KCBOT/\$500 × index number
- Mini-Value Line Index Future
KCBOT/\$100 × index number
- Standard & Poor's 100 Index Future
CME/\$200 × index number
- Standard & Poor's 500 Index Future
CME/\$500 × index number
- New York Stock Exchange Composite Index
Future
NYFE/\$500 × index number

Contract Face Value*

Open Interest* **

Options (regulated by SEC—\$100 × index number)

- S&P 100 Index Option/CBOE
- S&P 500 Index Option/CBOE
- Major Market Index Option/AMEX
- Market Value Index Option/AMEX
- NYSE Composite Index Option/NYSE
- (“Narrow Based” options)
- AMEX Computer Technology Index/AMEX
- AMEX Oil & Gas Index/AMEX
- S&P International Oils/CBOE
- S&P Computer/Business Equipment/CBOE

Futures-Options (regulated by CFTC)

- Standard & Poor's 500 Index Future-Option
CME/Value = same as future
- NYSE Composite Index Future-Option
NYFE/Value = same as future

* As of 10/26/83

** “Open interest” is the actual number of contracts outstanding at the close of a given trading day (puts and calls combined for options).