Ten Cautionary Rules for Institutional Investors

It's always better to learn from others' experiences before you learn from your own. The following guidelines about futures could serve as a start.

By Andrea M. Corcoran

The word among opinion leaders in the financial community these days is that futures and options can be extremely useful in managing risk and improving returns. Indeed, no financial executive can truly stay abreast of the times without becoming knowledgeable about these intruments. Futures, and in particular interest rate and stock index futures, are the newest innovations in portfolio management.

Futures contracts, unlike cash forward commitments, are standardized and fungible, and futures markets tend to provide more liquidity especially in distant contract months, so that contracts can easily be opened and closed to suit the unique demands of each trader. Moreover, futures markets are offset markets where delivery is not necessarily contemplated and price changes can be directly realized by closing out the contract at any time.

These markets are designed to eliminate the credit risk of doing business with the opposite side of the market. Every designated futures exchange clears its trades and assigns profits and losses daily through a clearing organization which stands behind all transactions among clearing member firms—essentially guaranteeing the performance of each contract. The resulting reduced credit risk is reflected in truer prices and greater market efficiency. All futures brokerage firms must meet mandatory minimum capital requirements, exchanges are required to place limits on speculator positions in any contract in order to prevent market manipulation, and trading is subject to regular surveillance by both the exchanges and the CFTC.

The flexibility of futures and options allows traders substantial leeway to design and implement hedges and other risk management strategies tailor-made to their individual commercial needs. Indeed, some techniques such as asset timing and allocation strategies can be best performed with futures because of the low cost of using index instruments, the ability to retain a fixed cash portfolio while adjusting market exposure with derivative products, and the fact that large purchases and sales can be executed without moving market prices. These trading activities are not hedging in the traditional sense, since they do not necessarily balance exchange and cash positions. If properly designed, however, they may be incidental and prudent uses of the market.

PRUDENCE STANDARD

Current economic uncertainty has elevated the need for institutions to insure against possible adverse changes in interest rates, currency values, and other economic factors. To the extent that firms are subject to a prudence standard, "prudence" now may require not only due care in using time-honored investment products but also making certain that new methods for managing risk are not overlooked. For many commercial firms, futures and options offer possible new approaches to reduce systematic portfolio risk and capital erosion due to cyclical markets and volatility.

Despite the advantages, these markets also are unfamiliar, and using them is different from dealing through informal networks or through established relationships such as the interbank market. Futures and options have traditionally had public reputations as risky, highly speculative forums where free-wheeling insiders play for high stakes. The colorful folklore of commodity trading dates back to Jay Gould and Jim Fisk and the "Black Friday" gold panic of 1869 and goes up to allegations of price manipulation in silver by the Hunt family in 1979 and 1980, and most recently to the description of traders' lifestyles in *The New Gatsbys*.

From my vantage point as director of the CFTC's division of trading and markets, I see both sides of the story. While the benefits of futures and options are real and substantial, the need for oversight caution and a well-informed approach is also clear. It is not impossible for well-financed, prudently managed institutional traders to be seriously

harmed as a result of their market experience even if they are merely hedging.

Despite the logic of financial self-interest, otherwise prudent businessmen too often are tempted or pressured to maximize short-term gain at the cost of jeopardizing the longer term financial health of their business or even personal accounts. The situation for large institutions is not terribly different from that of small investors who are victimized by bucket shop scam operators who make remarkable profits by peddling "get rich quick" deals using hard-sell telephone tactics. In both cases, normally conservative people suffer unnecessary and sometimes tragic losses because they allow greed to eclipse their better judgment.

GUIDELINES

Most or all of the external, noneconomic risks of doing business in these markets can be avoided through basic common sense guidelines without losing the opportunity to take full advantage of trading techniques. While some of these points may sound rudimentary, the record is unfortunately cluttered with cases of firms who thought they knew better.

1. *Have a strategy.*

A firm's decision to trade futures and options should be deliberate and defined. For instance, it may want to hedge exposure to economic factors such as changing interest rates or currency values, or to protect the value of a specific portfolio, or to to buy or sell financial instruments. Whatever the purpose, know what you want to accomplish in advance, and design your strategy around that goal.

Many regulators governing banks, pension funds, insurance companies, and other financial institutions have specific rules requiring at a minimum prudence and at a maximum specific indications on permitted and prohibited transactions. Some of these provisions are very narrow, permitting institutions to hedge only specific assets or trade certain contracts such as Treasury bonds. Some reflect outdated experience and make little sense with today's markets, such as precluding the use of "puts."

As arbitrary as they may seem, it makes sense to stay within the rules. Rules of prudence may allow arbitrage, other synthetic trades and quasi-speculative strategies while hedging does not. If regulations require hedging specifically, beware of so-called "dynamic hedging" strategies, some of which may create more exposure to market movements than they offset. There is an inevitable temptation of being drawn beyond the original strategy once a firm's trading department thinks it "understands" the marketplace and may want to actually speculate on price trends. Having an explicit strategy, based either on government regulations or prior self-analysis, will help restrain this impulse.

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2. *Don't cut corners.*

Trading futures or options can require substantial overhead costs, including the purchase of sophisticated computer hardware and software, trader salaries, economists, support staff, brokerage commissions and other fees. A poorly managed or staffed trading operation can make mistakes and, because of the large economic leverage in futures markets and market volatility, mistakes can be costly.

For instance, using a brokerage firm charging lower commissions may help reduce trading expenses, but in some cases may also result in receiving poor quality fills on market orders. While large firms may be able to negotiate favorable fee arrangements with certain brokerage houses based on the size and volume of their business, be sure that the brokerage has the capacity to carry the account, that it is adequately capitalized and staffed, and is well regarded in the industry. Finally, an effective trading strategy can be extremely complex, and it is certainly worth having effective data processing capability in place and experienced professionals at hand to make the system work.

3. *Know and understand the risks.*

While hedging provides an effective tool to manage inventory price exposure, the hedging mechanism itself is not totally risk free.

Classically structured hedges, for instance, do not eliminate "basis risk," that is, the possibility of change in the futures-cash price differential. Similarly, even fully hedged positions can generate serious credit demands from adverse price movements because of the unequal operation of mark-to-the-market margining. Theoretically, for instance, a hedge position with short futures contracts balanced against physical inventory creates no economic hazard—as prices rise, losses on the short futures are presumably matched by inventory appreciation. The losses on the exchange short positions, however, take the form of variation margin calls requiring daily payment in cash, while the offsetting gains in inventory value are not realized until the cash commodity is actually sold at some future time. In order to maintain the hedge and satisfy exchange cash demands in the interim, hedgers may be forced to borrow extensively on their various lines of credit.

4. *Be careful with whom you do business.*

While futures regulations are designed to eliminate the credit risk of doing business with industry firms, the recent case of Volume Investors Corp. demonstrated a gap in this protection.

Volume Investors, a clearing member firm on COMEX and other exchanges, was forced to default on sizable margin calls to the COMEX Clearing Association last March after a two-day gold price surge caused three customers with large short positions to default on margins to Volume. After being placed into receivership at the request of the CFTC, Volume was unable to cover claims by about 100 nondefaulting public customers with money in segregated accounts at the firm. COMEX Clearing made good some $9 million in Volume losses to the other side of the market. The clearinghouse guarantee, however, did not apply to Volume's own nondefaulting customers.

The Volume Investors scenario, while rare, cannot be ignored. Wherever a customer default is too large to be covered by firm capital, causing the firm itself to default, then margin funds for nondefaulting customers held at an exchange clearinghouse may be transferred to the other side of the market and thus lost. The result is that each customer bears a risk that his brokerage firm is adequately funded and that other large customers will pay their bills.

Prudence and sound business practice can help institutional traders to avoid a Volume Investors-type bind. If an institution is large enough to establish its own futures commission merchant (FCM) or clearing affiliate, for instance, it should consider this as an option. In any event, any firm planning to funnel much of its business through a particular brokerage house should check the house's credit and industry reputation carefully.

Most industry professionals must register with the CFTC and/or the National Futures Association, and you can inquire through the CFTC's office of communications and education or the NFA information center to learn whether the firm or individual is, in fact, properly registered and, in the case of CFTC registrants, whether the Commission has brought any enforcement actions against the registrant, and the nature and outcome of any such action.

5. *Use your market power to negotiate favorable arrangements.*

Institutional customers should be careful in establishing or extending agreements with brokerage firms, particularly on such points as determining when they are entitled to withdraw excess margin from their accounts and who is entitled to the interest accrued.

To the extent that firms are subject to a prudence standard, "prudence" now may require not only due care in using time-honored investment products but also new methods for managing risk.

Unless it makes its requirements specific, others may earn off the firm's uninvested funds. Large institutions have bargaining power and should use it. Investigate third party custodial agreements and different formats for margin, dispute resolution, notice requirements, and so on. Similar care should be applied in negotiating with trading consultants or advisors.

6. *Have strong internal controls.*

The complex financing arrangements surrounding futures and options make strong internal controls essential to any significant trading operation both to detect developing problems and to prevent abuse. For instance, systems can be designed to insure that a firm's account cannot be used by individual executives to conduct their own personal trading. Similarly, if margin and other expenses suddenly become disproportionate, firms should have an early warning system so that the problem can be identified and addressed before losses mount up.

Many of the problems which we see at the Commission stem from this area. Some firms, for instance, have allowed their individual traders to receive their own confirmations on executed trades rather than funneling this information through a central firm desk, opening a wide door for abuse. Attention to detail, effective internal management and efficient supervision can prevent unpleasant surprises.

This concern also underlies recent problems besetting certified public accountants. An auditor's comments on the financial condition of a publicly held corporation can substantially affect that company. Negative comments can damage the ability of a company to borrow money or maintain the price of its stock. A recent trend has emerged for businesses with questionable financial profiles to pressure auditors into giving positive opinions, or even to fire an auditor who discloses unpleasant truths—in a sense killing the messenger if the news if bad.

Last April, the Securities and Exchange Commission felt obliged to issue a public warning to both the accounting profession and publicly held companies against the practice of "shopping" for favorable audit opinions.

Certainly, no prudent business can plan or function effectively unless it receives honest and accurate advice about its own financial condition and the financial condition of those with whom it does business. As a result, one would expect company officials to welcome an auditor's blunt assessment of their firm's strength and weaknesses as a basis for effective long-range planning. Nevertheless, the pressure on managers to produce consistent positive results for one fiscal quarter after another can cause them to cut corners. The result can be disastrous.

7. *Keep your credit lines ample.*

Futures markets are notoriously unpredictable, and although a hedge should be a complete protection in the long run, it also requires the ability to stay in the market, as the exchange cash flow system requires that all gains or losses be marked-to-the-market and paid on a daily basis.

As a result, you may pay significant margin even on perfectly bal-

anced hedge positions. Failure to pay margin can result in premature liquidation of market positions, frequently to your distinct disadvantage. However, in most cases near term cash demands on properly structured hedges will be offset by gains later on. Be sure that your firm has access to credit on a rapid basis, and that lenders understand the nature of futures trading and are comfortable with market activities.

8. *The best laid plans can go wrong.*

Have a contingency plan. Most financial crises in futures trading occur when markets take an unanticipated dip or rise, such as the $44 per ounce gold price surge prompting losses at Volume Investors Corp. Because of the large economic leverage on futures and certain options contracts, small price movements can be magnified into enormous gains or losses. A prudently structured and implemented trading plan should allow a firm to weather the spikes and corrections of the marketplace without creating undue strain, as has happened during the recent period of currency volatility.

However, be prepared for the unexpected. Lawyers, in drawing plans, should consider the worst case scenario—the post-default game plan even if default is an extraordinary occurrence. Know what the worst case risk is and plan to avoid its consequences. A commercial trader, for instance, even without regulatory restrictions, may want to explicitly limit the amount of capital invested in futures and options at any one time.

9. *Know the rules.*

Institutions entering into futures and options trading will find themselves subject to a new set of rules separate and apart from those for securities trading or from their core business of banking, insurance, or finance.

For one thing, they will come under the jurisdiction of the Commodity Futures Trading Commission, which by federal statute is the exclusive regulator of all domestic trading in futures and commodity options. It is not uncommon for prominent institutions to contact me at the last minute unaware that they need approval from the Commission—possibly in addition to approvals from their usual bank of insurance or regulatory overseers—before launching a new financial venture. Similarly, major FCMs have found themselves in serious and embarrassing noncompliance with Commission rules requiring minimum capitalization for commission merchants or other basic standards, because they were not thoroughly familiar with the scope of the CFTC's requirements.

A poorly managed or staffed trading operation can make mistakes. Because of the large economic leverage in futures markets and market volatility, mistakes can be costly.

Similarly, while the CFTC's new rule 4.5 exempts many banks, pension funds, and other financial institutions from registering as commodity pool operators where their market activities are limited to conservative portfolio management strategies, the rule is not self-executing, and institutions which fail to apply for the proper exemption may find themselves in violation.

10. *Understand your regulator.*

Contrary to some popular opinion, the CFTC does not exist for the purpose of deliberately frustrating legitimate commercial ventures in futures and options.

Rather, as the exclusive federal regulator of domestic futures and commodity option trading, the CFTC's role is to attempt to assure that trading takes place in a safe, fair, and economically efficient environment. The regulations and statutes which we enforce are designed for the specific purposes of maintaining the fiscal integrity of the marketplace, preventing price manipulation or abnormalities, and protecting small customers.

Because of our public responsibility to market users, we at the CFTC stand ready to work with institutions in addressing our requirements and in improving them. While some CFTC regulations may appear complex and perhaps arbitrary, understand that we are open to advice. CFTC attorneys are always available to speak with public customers to explain the rules, discuss problems, and hear views on policy matters. Also, through the CFTC's office of communications and education, we provide certain regular services to market participants, including publication of Commission rules and interpretative letters and economic analyses of designated markets. The CFTC's weekly advisory calendar, available to the public at a subscription rate of $65 per year, will keep you posted on CFTC regulatory proposals, reparations actions, market designations, and proposals for public comment.

Regulation at both the governmental and exchange level assumes that players at each level—including individual or institutional customers—are cognizant of and responding to their own financial self-interest in making market-related decisions. It is presumed, for instance, that customers take care in examining whom they choose to do business with, that they monitor their own trading closely, and that they learn the rules of the game. While we at the CFTC can often help if things go awry, traders, and particularly large institutions, must also remember not to let enthusiasm obscure or overcome good business judgment in the marketplace. **IM**

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