Viable and Safe Markets— The Role of the Commodity Futures Trading Commission

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This is one in a series of articles *National Journal* will publish on the futures industry. These papers will provide the foundation for discussions at The Government Research Corporation's conference, "The Futures Markets and National Policy: An Agenda for the 1980s," to be held in Washington, D.C., October 5-6, 1983.

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The federal government has had an active role in the regulation of U.S. futures markets in one form or another for over sixty years. The evolution of federal market regulation has been the product of a number of influences, beginning with populist protection of agricultural interests in crop prices, exchange concerns over differing state laws and, more recently, protection of public market participants. Since futures trading was developed in agricultural markets, and was mostly confined to those markets until the 1970's, early federal regulation of futures trading was administered by the U.S. Department of Agriculture.

Throughout its evolutionary process, the purpose of federal regulation of futures markets has always been prevention of market manipulation and fraud, and has had self-regulation as its centerpiece. This approach generally has proved effective because the futures industry itself has a strong and highly sophisticated tradition of self-regulation, dating back to the mid 1800s. The reputation of the exchange and the financial integrity of members is crucial to the success and even survival of the exchange, so there is considerable incentive for exchanges to prevent manipulation and fraud by regulating their members' activities.

The constitutional basis for the Commodity Exchange Act of 1936, and before it the Grain Futures Act of 1922, is the interstate commerce clause in recognition that futures trading provides economic benefits—risk management and price basing—important enough to be vested with a "national public interest." The federal regulator acts as a public interest "watchdog," to protect those economic benefits which can be vulnerable to abuses by would-be market manipulators or defrauders. While the modern federal commodity statute still retains the fundamental presumption of industry self-regulation, Congress has determined that maintenance of safe and viable commodity futures markets requires the existence of a government "regulator of last resort." That is, self-regulatory organizations have the primary responsibility to prevent fraud and manipulation, but the Commission can step in to supplement or complement self-regulation where necessary and stands ready to act directly in areas to which self-regulatory rules do not extend.

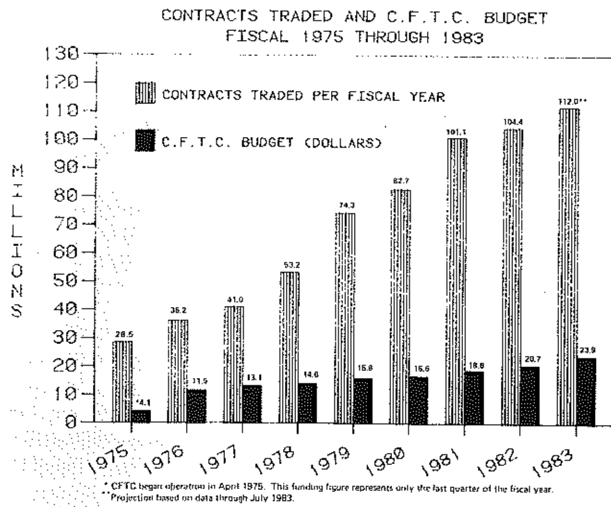
The Commodity Futures Trading Commission (CFTC) itself is a newcomer to the federal scene, created by Congress in 1974 and opening its doors the next year. Yet already, the CFTC has undergone two major Congressional reauthorizations (in 1978 and 1982), and its regulatory program has been vigorously tested in several periods of market turbulence. The CFTC is also among the federal government's smallest agencies—its annual budget of less than $25 million represents about two hours' interest on the national debt, and its total staff of under 500 has barely grown since the agency began eight years ago (see budget charts).

At the same time, however, the futures industry in America has experienced a period of phenomenal growth and diversification. The volume of futures trading on U.S. exchanges grew from 13.6 million contracts in 1970 to 112.4 million in 1982, up over 725 per cent in 12 years. This explosive growth is also seen in the range of products now being traded under futures contracts—foreign currencies (introduced on the International Monetary Market in 1972), heating oil (1974), U.S. Treasury bonds (1977), Eurodollars (1981), stock indices (1982), and options on futures contracts (1982).

The CFTC takes some pride in having encouraged a favorable regulatory environment for this industry expansion. U.S. exchanges are recognized as world-wide leaders not only in the trading of futures contracts but in the development of new products. The recent jurisdictional accord with the Securities and Exchange Commission which was partially codified in the CFTC's 1982 reauthorizing legislation also opened the door for the development of both new futures and securities products.

The CFTC today approaches its responsibility to protect the public interest in safe and viable markets

through a regulatory program structured around three central prongs: [See regulatory chart]



*CFTC began operations in April 1975. This funding figure represents only the last quarter of the fiscal year.
**Projection based on data through July 1983.

- *Oversight of futures exchanges* to prevent market manipulation and ensure that these key self-regulatory bodies effectively meet their responsibilities to both their members and the trading public;
- *Regulation of commodity professionals* to ensure that whoever sells futures to the public, handles customer funds, or performs customer transactions is fit, financially sound, and above board in their business dealings; and
- *Enforcement*, to ensure that those who defraud the public, abuse the marketplace, or violate federal statutes are duly prosecuted.

This regulatory system has evolved for over sixty years in a manner specifically tailored to futures markets and their participants. The fact that futures regulation *differs from* other forms of market regulation such as securities regulation simply reflects the fact that futures markets themselves differ from other market trading environments in terms of the contracts traded, their economic purpose, and exchange trading practices. As markets grow more interrelated, the CFTC and other relevant agencies, such as the SEC, can and have made appropriate changes to their regulatory programs to reduce duplicative requirements while maintaining effective standards for traders who participate in markets under several regulatory jurisdictions.

REGULATION OF EXCHANGES

The primary forum for futures trading in this country is the futures exchange. In fact, federal law prohibits the trading of futures contracts any place other than on a designated exchange. For this reason, the exchanges represent a principal regulatory focus for the CFTC.

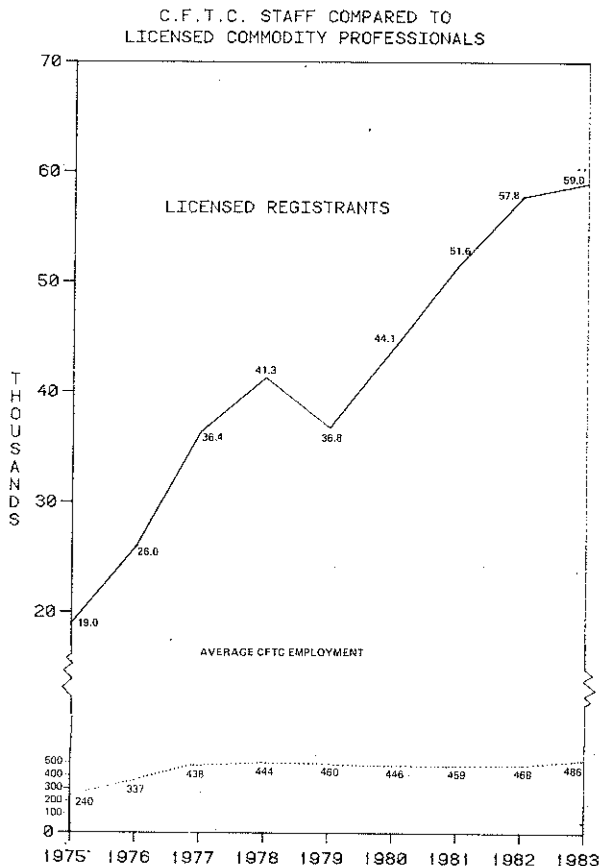
Federal law gives the exchanges primary responsibility for running their own business: writing rules for trade practices, setting margin levels, declaring emergencies, disciplining members, and so on.

However, as federal overseer, the CFTC's regulatory authority over futures exchanges is extensive. For instance, the CFTC:

- Designates (licenses) exchanges as "contract markets" for trading futures contracts. To approve a contract, the CFTC must determine that the contract meets the "economic purpose" test of facilitating price basing or commercial hedging and that it is "not contrary to the public interest." Mere speculative interest in an instrument will not support CFTC designation;
- Conducts periodic rule enforcement reviews of each exchange to ensure that the exchange is effectively enforcing its own regulatory program, and that the program is in conformance with the Commodity Exchange Act. Where deficiencies are found, the CFTC can take actions against offending exchanges, requiring rule changes, assessing civil monetary penalties or, ultimately, revoking their contract market designations;
- Reviews and approves all significant exchange rules except rules relating to the levels of futures margins.

The CFTC's most important responsibility with respect to exchanges, however, is to prevent price manipulation. When futures or cash prices are distorted or artificial, then market efficiency is lost, and all traders are harmed. The price basing utility and hedging effectiveness of futures contracts depend upon futures prices reflecting the fundamental forces of supply and demand. Congress has made price manipulation a federal felony punishable by up to five years in jail and fines of up to $500,000 per violation.

The CFTC's most direct approach to these problems



*CFTC began operations in April 1975. Figures for fiscal 1975 represent initial levels.
**Estimate.

is its market surveillance program. All active futures markets are monitored on an ongoing basis so that, at any given time, CFTC can accurately determine the identity of large or key traders, the size and nature of their positions and transactions, their market intentions, supply conditions or potential congestions, and whether futures prices are in line with the economic fundamentals of the underlying commodity. Often, this surveillance process involves close contact with other federal government agencies like the Federal Reserve Board or the Department of Agriculture, or will include tracking the capacity of large brokerage or commercial firms to meet their financial obligations in volatile market swings.

Although the first line of defense to a potential market manipulation or abuse is the exchange, CFTC's arsenal of remedial tools is diverse and effective, ranging from emergency powers to suspend trading, impose margins, or force a contract's liquidation, to more subtle (and often more effective) means such as persuading key traders to act responsibly. Often the CFTC and the exchange work together to defuse a potential market problem. The CFTC will avoid actual government intervention in an active market so long as the self-regulatory body is addressing the situation effectively and responsibly.

Emergency powers are employed by the Commission and the exchanges only as a last resort. There is a strong resistance against anyone—government or exchange—stepping in to interrupt market processes, or change the terms of the contract or other trading rules in mid-stream.

Just as important are steps the CFTC takes to prevent market abuses or market congestions frfom occurring in the first place. For instance, the CFTC now requires that speculative position limits be placed on all futures contracts—helping to prevent any speculator from accumulating a big enough concentration of contracts to squeeze or corner a market. Similarly, the CFTC requires that new contracts be designed (or old ones redesigned) to avoid possible congestion, particularly in the delivery process.

The success of this system can best be seen in the fact that, since April 21, 1975, despite the literally hundreds of futures contracts which have matured during that period, the CFTC has employed its market emergency powers only four times.

REGULATION OF MARKET PROFESSIONALS

Beyond the exchanges, the CFTC's regulatory umbrella reaches a large community of firms and market professionals who deal with the public. For these brokers, trading advisors, sellers, commodity pools, and futures commission merchants, the CFTC has a responsibility to assure that registered industry professionals are solvent, professional and trustworthy.

Federal involvement in this area provides a service by setting standards for market professionals. An individual farmer in the Midwest, for instance, hardly has the resources to check the capitalization of a large brokerage firm that conducts his agricultural hedge transactions. Nor can novice individual traders be expected to protect themselves from over-aggressive salespeople failing to mention that futures involve risks, as well as opportunities.

While no firm data exist on this point, the recent dramatic rise in futures trading volume and diversity of new instruments has likely brought many new participants into the futures arena, and the number of commodity industry professionals has quickly grown to match the expanding market. The number of brokers, sellers, and other professionals registered with the CFTC jumped from 36,000 in 1979 to over 56,000 in 1982—creating a large pool of entrepreneurs now competing for customer business.

The CFTC's program of policing the futures sales and professional community is tailored directly toward protecting against fraudulent or unfit professionals. For instance, brokers must:

- register with the CFTC and maintain that registration on an ongoing basis along with all other commodity professionals. This registration process includes FBI and SEC background checks on all applicants to weed out individuals with law enforcement or regulatory records, and will soon include uniform proficiency examinations;
- segregate all customer funds from firm and personal funds, subject to strict accounting standards;
- satisfy minimum financial standards (called "net capital rules") to ensure that they have enough capital to remain solvent in turbulent market conditions; and
- provide all new customers with a specific brief disclosure statement (the exact wording of which is set by CFTC) identifying the risks of futures trading. The customer must then sign the document to confirm having received and understood it.

The CFTC also administers a special "reparation" court system specially designed for aggrieved futures customers seeking redress from CFTC registrants for violations of federal commodity laws, and voluntary arbitration is also available through the exchange or the National Futures Association. Federal law also provides an explicit "private right of action" for aggrieved futures customers and implicit private rights of action under the Commodity Exchange Act have now been affirmed by the U.S. Supreme Court.

In this area too, the emphasis on industry self-regulation is being stressed by both Congress and the CFTC. In September 1981, the CFTC registered the National Futures Association (NFA) as a self-regulatory organization specifically governing the broad futures trading community which deals with public customers—analogous to the National Association of Securities Dealers (NASD) in the securities field. Already, NFA has taken substantial steps toward setting up a viable organizational structure and putting in place a strong regulatory program. As an industry self-policing force over futures professionals, NFA will well complement the CFTC's efforts to protect public traders, with specific responsibility for registration, testing programs, arbitration and financial auditing.

ENFORCEMENT

The CFTC's enforcement arm serves two vital functions in the regulatory scheme. First, the Division of

Enforcement provides the muscle behind any federal sanctions against market manipulation, customer fraud, trading abuse, or failure by parties to comply with CFTC actions. Enforcement can proceed directly in administrative and civil judicial forums and refers criminal violations to the Department of Justice.

Beyond this, however, particular attention has been focused on the very disturbing phenomenon of swindlers and "boiler room" operators committing frauds involving "commodities." According to a report by the Senate Subcommittee on Investigations, "an average of more than $200 million a year is lost to 'off exchange' commodity fraud." Whether this number is overstated or not, the problem is clearly large, and of serious concern to the CFTC.

During Congress' consideration of the CFTC's 1982 reauthorization statute, the Commission proposed several statutory amendments to strengthen antifraud investigatory and prosecution efforts, including several steps to better involve state government prosecutors in this effort. Most of these amendments are now public law. The CFTC is currently undertaking to strengthen its Enforcement staff through increased budget and personnel commitments and is also exploring additional ways to involve the states in antifraud initiatives.

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This brief, cursory view of the CFTC's program is meant to demonstrate the basic approach underlying modern futures regulation. Commodity futures contracts permit a very specialized form of economic interaction to occur among market participants who wish to transfer price risks. Some futures traders decrease their cash market price exposure through hedging transactions while others assume that risk via speculative transactions. All of this activity takes place in a structured exchange trading environment developed over more than a century of trial and improvement. Some of the most important customer protections of futures markets are found not in the rules of either the CFTC or the exchanges, but rather are simply inherent in the way trading is conducted among firms acting in their own self-interest.

For instance, since futures are designed to be used by large commercial interests for risk management purposes, contracts are generally large, covering for example, 5,000 ounces of silver, 42,000 gallons of heating oil, 5,000 bushels of wheat, or $1 million of Treasury bills. This level of magnitude, which could translate into large daily margin calls, is often enough to persuade prudent investors not to get involved beyond their means. In lieu of formal "suitability" rules covering futures trading, futures brokers are directly responsible to the clearing house if their customers cannot meet their fiscal obligations. Thus, these brokers regularly set high financial requirements for futures customers.

The possibility of inadvertently disrupting this unique system of checks and balances underlies many concerns about current proposals for "regulatory equivalence" between futures and securities, or for greater federal control over futures margin-setting.

It may sound reasonable on its face, for instance, to apply parallel margin rules to both futures and options on stock indices. Both instruments, after all, base their values on groups of stocks and can serve similar investment strategies. But here the similarity ends. The Federal Reserve Board can declare an across-the-board 30 per cent margin level for all short uncovered options. For futures, however, margin levels are directly keyed to price volatility, supply levels, and market conditions. Margins set too high will rob the market of liquidity, adding to price instability. Margins set too low can leave firms vulnerable to unpaid debts or financial insolvency. In a market emergency, margin levels can be set and reset several times in a matter of days.

So long as the CFTC retains its emergency authority to intervene in the exchange margin-setting process when market turbulence so requires, the circle of regulatory checks and balances remains complete, and the public is protected.

Similarly, while rules prohibiting corporate "insiders" from using non-public company information to gain an unfair advantage in trading corporate stocks or single-stock options are well established in the securities field, the application of these "insider trading" rules to futures is less clear cut. Futures prices reflect worldwide forces of supply and demand for an underlying product and are generally beyond the influence of any single company, making it unlikely that a company official could benefit from "inside information." The CFTC is currently conducting a study of the general use of non-public information in the futures context and related public policy concerns, mandated by the 1982 reauthorization act, which should be completed by September 1984.

While some have suggested that the differences between federal regulation of securities and commodities create a "regulatory disparity" which will produce a "race to the bottom" toward weaker controls, the evidence often points to the contrary. Federal regulation governing economic activity or providing services exists only because the public demands it, and the affected industry accepts it. The motivating factor is that the market participants [and innocent bystanders] want to be protected. Futures traders go to the broker or exchange where they can get the best and fairest execution of their transactions. Members of the public have often chosen to deal where they receive the most protection, voting with their feet against that "race to the bottom."

The industry also benefits from strong effective regulation, since its business is very much dependent on the public having confidence in the stability, safety, and solvency of exchange trading floors and brokerage accounts.

There is, of course, also a limit to regulation. Once government protections are allowed to become too costly, too burdensome, or ineffective, then the public will vote not only with its feet, away from the poorly regulated and expensive market, but will also vote with its ballots for political proponents of regulatory reform. The CFTC, like other federal agencies, must perform a delicate balancing act in this regard. Congress mandates not only that we regulate effectively in the public interest, but also that our rules be cost-effective and make economic and practical sense. While this dual responsibility makes our jobs as regulators more difficult, it causes us to constantly reevaluate our regulator programs which is probably not a bad way of doing the "public's business." □