

Congressional Research Service

Report RL30434

# *The Commodity Futures Modernization Act of 2000: Derivatives Regulation Reconsidered*


Mark Jickling, Government and Finance Division


January 29, 2003


**Abstract.** In December 2000, Congress passed the Commodity Futures Modernization Act, the most significant amendments to the Commodity Exchange Act in 25 years. This report describes the historical market developments and the major issues that shaped consideration of that legislation.

Order Code RL30434

# Report for Congress



# The Commodity Futures Modernization Act of 2000: Derivatives Regulation Reconsidered

**Updated January 29, 2003**

Mark Jickling
Specialist in Public Finance
Government and Finance Division

# The Commodity Futures Modernization Act of 2000: Derivatives Regulation Reconsidered




## Summary

In December 2000, Congress passed the Commodity Futures Modernization Act, the most significant amendments to the Commodity Exchange Act in 25 years. This report describes the historical market developments and the major issues that shaped consideration of that legislation.

In 1974, Congress created a new independent agency, the Commodity Futures Trading Commission (CFTC), to oversee trading in derivative financial instruments. Derivatives – which are used to avoid risk of price changes in some underlying commodity or financial variable *or* in search of speculative profits from the same price changes – were on the verge of a major expansion: from contracts based on farm commodities and minerals to "financial futures" based on bonds, currencies, and interest rates. The Commodity Exchange Act (CEA) amendments in 1974 gave the CFTC exclusive jurisdiction (with some exceptions) over derivatives regardless of the nature of the underlying commodity or interest.

During the 1980s, however, a new derivatives market grew up, where neither the CFTC nor any other agency exercised comprehensive oversight. Derivatives can now be divided into exchange-traded (CFTC-regulated) instruments and over-the-counter (OTC) instruments. The two types of instruments serve the same economic functions and are often in direct competition. However, the existence of two markets, where the 1974 Commodity Exchange Act amendments envisioned a single market regulated by the CFTC, led many to conclude that the CEA was out of date and in need of major revision.

The futures exchanges contended that CEA regulation put them at a competitive disadvantage versus the unregulated OTC market. OTC market participants claimed that the CFTC's exclusive jurisdiction under the CEA created legal risk for them: OTC contracts could possibly have been invalidated by a court finding that they were in fact illegal, off-exchange futures contracts. Both groups viewed the CEA as an impediment to financial innovation and portrayed themselves as vulnerable to foreign competition.

A joint group of U.S. financial regulators recommended in 1999 that the CEA be amended to 1) exclude certain OTC derivatives from the CEA and 2) permit the deregulation of financial futures (except when they are marketed to small investors), on the grounds that these contracts are less susceptible to manipulation than physical commodities. This was the general approach followed by the Congress in enacting the Commodity Futures Modernization Act of 2000.

This report analyzes the transformation of derivatives markets and the legislative response and will not be updated. The legislation passed by the106$^{th}$ Congress, the Commodity Futures Modernization Act of 2000, is described in CRS Report RS20560, *Derivatives Regulation: Legislation in the 106$^{th}$ Congress.*

## Contents

Background . . . . . 1
Derivative Markets . . . . . 1
Development of Derivatives Markets . . . . . 3
Pre-2000 Regulation of Derivatives . . . . . 5

Regulatory Jurisdiction over Derivatives . . . . . 7
Regulation of OTC Contracts . . . . . 7
Deregulation of the Futures Exchanges . . . . . 9
The Issue of Fair Competition . . . . . 9

Other Regulatory Issues . . . . . 12
Single-Stock Futures and the Shad-Johnson Accord . . . . . 12

Conclusion . . . . . 13



## List of Figures

**Figure 1. Futures Contracts Traded on U.S. Exchanges, by Underlying Interest: 1999** . . . . . 4

**Figure 2. Notional Value of OTC Swaps versus Exchange-Traded Financial Contracts, 1991-99** . . . . . 5

**Figure 3. Futures Contracts Traded: U.S. versus Foreign Exchanges, 1991-99** . . . . . 10

# The Commodity Futures Modernization Act of 2000: Derivatives Regulation Reconsidered

This report analyzes the major issues that were involved in the consideration and passage of the Commodity Futures Modernization Act of 2000 (H.R. 5660; P.L. 106-554). The legislation that created the CFTC in 1974[1] contains a sunset provision: the agency must be reauthorized periodically. The CFTC's authorization expired on September 30, 2000. Reauthorization legislation has usually been the vehicle for consideration of regulatory issues related to futures and derivatives markets. The reauthorization legislation considered and passed in 2000 are described in CRS Report RS20560, *Derivatives Regulation: Legislation in the 106th Congress.* This report provides background on the major reauthorization issues.

The 2000 reauthorization process took place as many regulators and market participants were calling for a fundamental reevaluation of the Commodity Exchange Act (CEA), the statutory basis for the CFTC. Basic changes in the CEA and in the regulation of financial derivatives were proposed, and eventually enacted. Markets had changed dramatically since the CFTC was created, and the existing regulatory framework was under challenge from all sides. Some analysts claimed that CFTC-type regulation was unnecessary in most of the markets where it then applied, that it slowed financial innovation, and that it placed the U.S. futures and derivatives industries at a disadvantage relative to their foreign competition (much of which did not exist in 1974). On the other hand, some believed that deregulation (or the growth of unregulated derivatives markets) may pose serious risks to market participants and to the stability of the global financial system.

What is the appropriate framework for the regulation of financial derivatives? Which federal regulator should have jurisdiction over which forms of trading, and how can jurisdictional quarrels among regulators be prevented? To what extent can industry self-regulation be relied upon to maintain fair, stable, and efficient markets? These broad questions, the background against which Congress in 2000 weighed the future of the CFTC, are examined briefly in this report.

---

[1] The Commodity Futures Trading Commission Act of 1974, P.L. 93-463.

# Background

## Derivative Markets

Derivatives are financial instruments or contracts whose value is linked to the price of some underlying commodity or financial variable. There are several forms of derivatives – the best-known variations are futures contracts, options, and swap agreements – but all have this common central feature: two parties promise to make a transaction (or series of transactions) in the future *at a price that is agreed upon today*. It is expected that the underlying price or rate will fluctuate over the life of the contract, but the price specified in the derivative instrument remains fixed. If they succeed in forecasting the direction of prices, derivatives traders will be entitled to buy the underlying commodity for less (or sell for more) than the going market price. For every winner, there is a loser. Here are three examples:

- A trader who expects the February price of corn of $2.20/bushel to rise over the spring and summer may enter into a "long" futures contract, committing himself to buy 5,000 bushels at that price. (A promise to sell is a "short" contract.) If the price rises to $2.30, the contract gains value: the trader can buy 5,000 bushels at $2.20 (thanks to the futures contract), and sell them at the market price of $2.30, making a profit of 10 cents per bushel, or $500, which is credited to the trader's account.[2]

- An option to sell 100 shares of Cisco Systems stock at $120/share[3] has an intrinsic value of $1,000 if the current market price is $110 (100 X the $10 price differential). If the market price rises above $120, the option is "out of the money," and the holder will not exercise it. The difference between options and futures is that the option buyer is not obliged to make the transaction on unfavorable terms if prices fail to move as expected. In exchange for this right, the seller of the option receives a cash premium.

- A financial institution with large amounts of floating-rate debt fears that interest rates are about to rise, which would increase its debt service costs. It enters into an interest rate swap: it agrees to pay its swap dealer a fixed rate of interest on a principal amount equal to its



[2] Futures contracts are "marked-to-market" daily – losses must be paid up, and gains are credited to the winners' accounts. A trader may take his profits at any time up to the expiration of the contract by entering into an opposite, or offsetting, contract, so that his net obligation to buy and sell the commodity is zero. Holders of physical commodity futures have the option of settling the contract by making (or taking) delivery of the commodity itself at expiration, but only about 0.7% of U.S. futures contracts are settled this way. The rest are settled in cash.

[3] The original version of this report was written in early 2000, when many Internet companies' shares traded at over $100. In early 2003, Cisco trades at under $15/share, making the option described above profitable indeed!

outstanding debt,[4] and in return will receive a floating-rate payment on the same principal amount. Thus, if interest rates do rise, the swap payments it makes remains constant, while the swap payment it receives rises, allowing it to meet the rising claims of its floating-rate creditors. The swap converts floating-rate to fixed-rate debt.

Thus, the owner of a derivative gains or loses as the underlying price or rate changes, without actually owning the underlying commodity itself. Derivatives allow traders to take a position in markets at a fraction of the cost of buying an equivalent amount of the underlying item. A 5,000-bushel corn futures contract might require an initial cash outlay – called a margin payment – of about $500, even though the total underlying commodity value is $11,000. To buy 100 shares of Cisco (at $110/share) would also cost $11,000, but the premium (price) of the option described above might be less than $1,100.[5] Derivatives speculation is therefore said to be "leveraged," because traders take relatively large positions in markets with relatively little capital outlay. As a result, the effects of changes in the underlying commodity's price are magnified: if Cisco Stock rises by 10%, the option holder doubles his money. Leverage also implies the risk of large, sudden losses.

Derivatives are often described as bets on future price changes. This is not incorrect, but it is incomplete. Derivatives can be used to speculate, but they can also provide protection against the risk of unfavorable turns in prices or interest rates. On the other side of a corn speculator's contract might be a farmer who feared that prices in the fall would be even lower. Taking the short side would allow him to sell at $2.20/bushel, no matter how low the market price went. Similarly, the financial institution in the third example above uses an interest rate swap not to seek trading profits but to protect itself against a rise in interest rates.

Derivatives are used by businesses, units of government, and financial institutions to manage risk. Often, they permit the "unbundling" of risks in ways that give market participants greater control over the risks they assume. For example, the holder of a foreign bond faces two separate risks. That is, the value of the bond will fall if 1) interest rates rise or 2) the currency in which the bond is denominated loses value relative to the holder's domestic currency. Using derivatives, the holder may choose to assume either of these risks or to pass them off to someone else.

In sum, derivatives users can be divided into two groups, who use the markets for opposite purposes. *Speculators* seek to profit by anticipating future price changes, while *hedgers*, whose business generally involves them in the cash market for the underlying item, avoid price risk by transferring it to others (namely, the speculators).



---

[4] The principal in an interest rate swap is "notional," or imaginary. It is never actually exchanged, but serves as a reference point to determine the size of the swap payments.

[5] In addition to its intrinsic value (the difference between the market price and the option's exercise, or "strike" price) an option has time value – the probability that its value will increase before expiration.

## Development of Derivatives Markets

Derivatives began as an adjunct to agriculture. Producers, distributors, and processors of farm commodities devised futures, options, and forward contracts to protect themselves against rising or falling prices. These markets became the futures exchanges and flourished because of the existence of speculators willing to assume the risks that others wished to avoid. In the 1970s, the Chicago futures exchanges expanded the market dramatically by introducing contracts based on financial instruments: potential derivatives users now included not just producers and commercial users of commodities, but any business whose profits were affected by interest rates or foreign exchange rates. Today, as figure 1 shows, financial futures and currency futures account for about 2/3 of contracts traded on U.S. exchanges.

The success of financial futures attracted competition. In the 1980s, banks and securities firms — those who dealt in the actual stocks, bonds, and currencies underlying financial futures — began to offer swap contracts and options that had the same functions as exchange-traded futures. They could be used to hedge or speculate. Growth in these markets has been explosive, as figure 2 below shows.

The new derivatives market, where swaps and similar instruments are traded "over-the-counter" (OTC) or off-exchange, has grown much faster than the exchange-traded derivative market since its inception in the 1980s, in terms of the notional principal amount of contracts in force.[6] When other OTC instruments, such as options and forward agreements are included, the total notional value of the OTC market was $81.4 trillion in June 1999.[7]

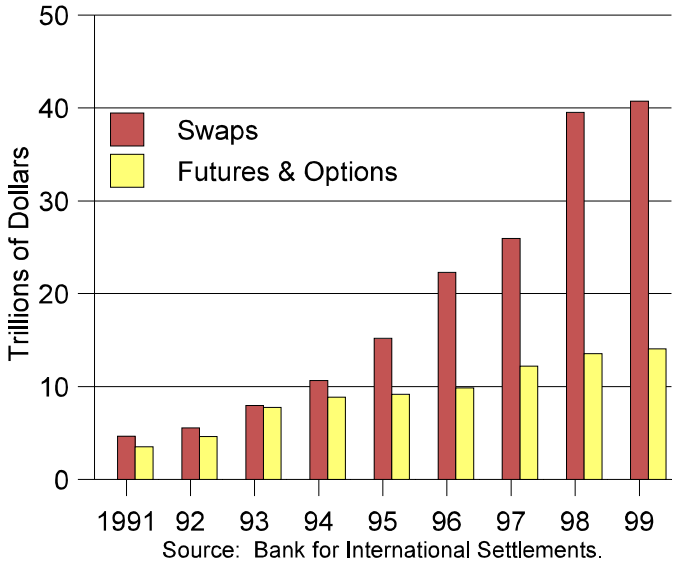
Traders often view OTC contracts and exchange-traded futures and options contracts as close substitutes. The over-the-counter and the exchange markets compete for the same business. A central issue for the CFTC reauthorization in 2000 was whether regulation under the CEA put the U.S. futures industry at a competitive



[6] Although notional principal is the only basis for comparing the two markets, it is not a very satisfactory measure. Notional value does not convey any useful information about the market value or riskiness of a particular instrument. Moreover, contracts are traded much more frequently on the exchanges, so that comparisons of value outstanding at the end of a period may be misleading as a gauge of total market activity.

[7] Bank for International Settlements. *The Global OTC Derivatives Market at end-June 1999*. November 1999. 5 p. (Available on the Internet at www.bis.org)

**Figure 1. Notional Value of OTC Swaps versus Exchange-Traded Financial Contracts, 1991-99**




disadvantage relative to the OTC markets, and to foreign futures exchanges.

## Pre-2000 Regulation of Derivatives

Federal regulation of futures trading dates from the Grain Futures Act of 1922 (P.L. 67-331), which became the Commodity Exchange Act. However, the major features of the pre-2000 regulatory framework date from 1974, when Congress perceived that derivatives markets were on the verge of expanding from contracts based on farm commodities and metals into "financial futures" – contracts based on government bonds, interest rates, and (later) stock indexes. In response to the growing economic scope and importance of futures trading, Congress replaced the existing futures regulator (an office within the Department of Agriculture) with an independent agency, the CFTC, with exclusive jurisdiction (with a few important exceptions) over all derivatives trading, regardless of the nature of the underlying commodity.

The CEA, as amended in 1974, specified that trading of derivatives – any contracts that were "in the character of" futures contracts – was to take place only on a registered futures exchange whose rules and practices were under CFTC regulation. The rationale for this grant of regulatory authority was that derivatives are susceptible to manipulation and excessive speculation, which can cause artificially high or low prices in the underlying cash markets, or, in extreme cases, instability and panic in the financial system. At a time when oil and other commodities were in short supply and prices were soaring, Congress sought a "strong law" to protect investors and to insulate the economy from the potentially distorting effects of derivatives trading, much as the Securities and Exchange Commission (SEC) was created in 1934 in response to the stock market crash of 1929.

However, the extension of "exclusive" jurisdiction to the CFTC had to take note of other agencies' claims. The major exceptions to the CFTC's exclusive jurisdiction were contained in the so-called "Treasury Amendment," part of the 1974 law. The Treasury expressed concern that exclusive CFTC jurisdiction would conflict with the U.S. government securities market and the foreign exchange market, where several forms of off-exchange contracts very similar to futures and options were in common use. These were professional markets, where small investors were not present, and were for the most part unregulated. They were, in the Treasury's view, performing in a satisfactory manner without significant government oversight. Therefore, Treasury saw no reason why these self-regulating markets should be brought under CFTC regulation. Congress wrote the Treasury Amendment into law, excluding contracts based on U.S. government securities or foreign exchange from the provisions of the CEA.

What no one could have foreseen in 1974 was the development of the OTC swap market. Despite the fact that swaps and futures serve exactly the same economic purposes, and are sometimes interchangeable, the CFTC generally exercised no regulatory authority over the OTC market. How did this market (now measured in the tens of trillions of dollars) develop outside the regulatory framework of the CEA? As the market was established in the1980s, the CFTC made no move to assert its jurisdiction: the major swaps dealers were large banks and securities firms, rather than the futures brokers that were CFTC registrants. Banking regulators took a laissez-faire attitude, perhaps viewing swaps as a welcome source of income for depository institutions whose recent results in commercial and international lending had ranged from poor to disastrous. Securities broker-dealers tended to locate their swaps business in unregulated affiliates, where SEC authority was extremely limited.

Still, a legal uncertainty remained. Could the courts rule that swaps were in fact "in the character of" futures contracts, and thus illegal and unenforceable unless traded on a CFTC-regulated exchange? In 1989, the CFTC issued an exemption for swaps, which was revised in 1993 (pursuant to the Futures Trading Practices Act of 1992, P.L. 102-546).[8] Under the terms of the 1993 exemption, swaps would not be regulated under the CEA as long as they met four conditions that distinguished them from exchange-traded futures:

- swaps may be traded only by "eligible participants," that is, financial institutions, corporations, governmental units, and individuals with assets over $10 million;

- the terms of swap agreements must be individually negotiated between the counterparties, rather than standardized contracts like futures and exchange-traded options;

[8] In April 1993, the CFTC issued a separate exemption for OTC energy derivatives: these would not be considered subject to the CEA as long as all parties were actually involved in the underlying energy businesses, all contracts were subject to negotiation as to their material terms, contracts were held to expiration rather than traded actively, and all trades involved only principals. See *Federal Register,* v. 58, April 20, 1993. p. 21286.

- the creditworthiness of the counterparty must be a material consideration in swaps transactions;[9] and

- there must be no "multilateral transaction execution facility," i.e., a swaps exchange.

In 2000, the financial swap market satisfied only the first of these conditions. Many swap contracts are standardized and fungible, and are traded short-term like any other financial instrument. Both in the United States and elsewhere, swaps exchanges and clearing houses had been introduced or proposed. Therefore, the legal uncertainty of possible conflict with the CFTC's exclusive jurisdiction remained, and there were concerns that the CEA and the CFTC exemptions were preventing the swaps market from adopting features of the exchange system (e.g., the clearing house) that would improve market safety and efficiency, or may have pushed such developments abroad.

Legal uncertainty in the U.S. OTC market was a major issue in the 2000 CFTC reauthorization. Market participants and regulators supported making the current exemptions from the CEA a matter of statute rather than regulation, thereby settling the long dispute over who does (or should) have regulatory jurisdiction over swaps. This was done by the Commodity Futures Modernization Act of 2000, as described in CRS report RS20560, *Derivatives Regulation: Legislation in the 106th Congress*.



# Regulatory Jurisdiction over Derivatives

## Regulation of OTC Contracts

Jurisdiction over OTC derivatives was a central issue in the 2000 CFTC reauthorization. Congressional efforts to address the issue in the past were made difficult by disagreements among federal regulators. A 1999 report issued by the President's Working Group on Financial Markets, however, showed that the regulators had reached consensus on this and some related issues.[10] The report recommended that swaps and other OTC markets should be excluded from the CEA, provided 1) that no retail investors are active in the markets and 2) that the contracts

---

[9] All futures contracts are guaranteed against one party's default through the exchange's clearing house, an association of exchange members, which in effect takes the opposite side of each trade. Thus, the creditworthiness of the other party is not a consideration to futures traders. Under the exemption, swap traders must assess and assume the risk of counterparty default themselves.

[10] President's Working Group on Financial Markets. *Over-the-Counter Derivatives Markets and the Commodity Exchange Act*. November 1999. 35 p. (Hereinafter cited as *Working Group Report*.) The Working Group consists of the Secretary of the Treasury and the chairmen of the Federal Reserve, the SEC, and the CFTC.

traded are not based on nonfinancial commodities whose supply is finite.[11] These recommendations proceeded from the regulators' conclusion that the two justifications for CEA-style regulation of derivatives – small investor protection and the potential for price manipulation – did not apply to the swaps market. That is, participants in that market are sophisticated and have the means to protect their own interests, and, secondly, manipulation of interest or exchange rates via the swaps market has not been observed in 20 years and is highly unlikely to occur in the future.[12] In short, the regulators argue that the swaps market is like the government bond market or the foreign exchange market, where the general, longstanding view is that no public interest is served by more than a minimal regulatory presence.

The choice before Congress in 2000 was whether to accept the recommendations of the Working Group. It could choose to exclude swaps from the CEA by expanding the existing exemption (to permit swaps clearing houses and exchange-like trading facilities) and making the exclusion a matter of statute rather than of regulation. The effect of such action, besides reducing legal uncertainty in the swaps market, would be to allow the OTC market to adopt features (clearing houses and multilateral trading systems) of the exchange markets – to strengthen self-regulation, in other words. Some viewed such changes in the marketplace as not only desirable in themselves[13] but essential to protect the U.S. industry. Federal Reserve Chairman Alan Greenspan testified on February 10, 2000 that

> ...I see a real risk that, if we fail to rationalize our regulation of centralized trading mechanisms for financial instruments, these markets and the related profits and employment opportunities will be lost to foreign jurisdictions that maintain the confidence of global investors without imposing so many regulatory constraints.[14]

The Working Group's implicit conclusion was that unregulated financial speculation is generally benign. The other view of speculation – embodied in the pre-2000 CEA – is that it may at times become excessive, and that artificial (and unwelcome) price volatility and market instability may follow. Accordingly, Congress could have chosen to apply to the OTC market some of the regulatory requirements that applied to the exchanges. The Working Group recommends that swaps clearing houses – which represent a concentration of risk[15] – should be

---

[11] While the Working Group did not recommend that "finite supply" commodities be excluded from the CEA, because of manipulation concerns, it did endorse the exemption for energy derivatives that the CFTC had issued in 1993, and urged that the CFTC retain and use its exemptive authority in those markets that it did regulate.

[12] Ibid., p. 16.

[13] A swaps exchange could mean greater transparency, as prices became available to all market participants. The ability to open and close positions quickly could increase liquidity, reducing the cost of hedging. A clearing house would reduce the cost of monitoring counterparties' creditworthiness, again possibly lowering the costs of hedging.

[14] Testimony before the Senate Banking Committee on the report of the President's Working Group on Financial Markets. Hearing, 106th Congress, 2nd session, February 10, 2000.

[15] A clearing house is a vehicle by which the market collectively assumes the risk of default, (continued...)

overseen by some federal regulator (or a foreign regulator that sets appropriate standards), but acknowledges that jurisdictional problems may emerge as differently-regulated institutions offer clearing services for contracts based on many different underlying interests.[16]

The Working Group report also recommended that currently unregulated OTC derivatives dealers should be required to disclose certain financial information to regulators, in order that the regulators may be aware of developing problems in the OTC dealer affiliate that may threaten the regulated parent firm, whose financial stability is a matter of public interest.[17] Other aspects of CEA- and exchange-type regulation that Congress could have imposed on OTC dealers include minimum capital standards, registration of personnel, reporting of large trades and market positions, various record keeping requirements, disclosure of transaction price and volume data, and so on. However, measures of this type would draw the objection that unilateral U.S. regulation will simply drive the business overseas.

The Commodity Futures Modernization Act of 2000 (CFMA) as enacted excludes financial OTC derivatives from CFTC regulation, provided that trading occurs only among "eligible contract participants:" financial institutions, businesses, government units, professional traders and brokers, institutional investors, individuals with over $10 million in assets, and so on, but *not* small businesses or individual investors. Derivatives based on agricultural commodities, on the other hand, remain under CFTC jurisdiction and can only be traded on regulated exchanges. All other commodities – including energy and metals – fall into a third category of "exempt commodities." OTC derivatives in exempt commodities may be traded among eligible contract participants without CFTC regulation, but certain CEA provisions against fraud and manipulation continue to apply to these markets.

OTC clearing houses and exchanges are subject to various disclosure and oversight provisions in the CFMA. The 2000 law contains no provisions requiring disclosure by unregulated derivatives dealers.

## Deregulation of the Futures Exchanges

### The Issue of Fair Competition.

OTC derivatives and exchange-traded financial futures contracts are direct competitors in the marketplace. Before the 2000 legislation, the futures exchanges contended that the unregulated status of the OTC markets constituted an unfair competitive advantage. The pre-2000 CEA required the exchanges to submit rule

---

[15] (...continued)
removing the risk that a single swaps dealer could be hurt by a customer default. On the other hand, a clearing house failure – during a severe market disruption – could cause wider systemic problems than a single dealer failure.

[16] *Working Group Report*, p. 19. The report does not make specific recommendations as to the kind of regulatory oversight that would be desirable.

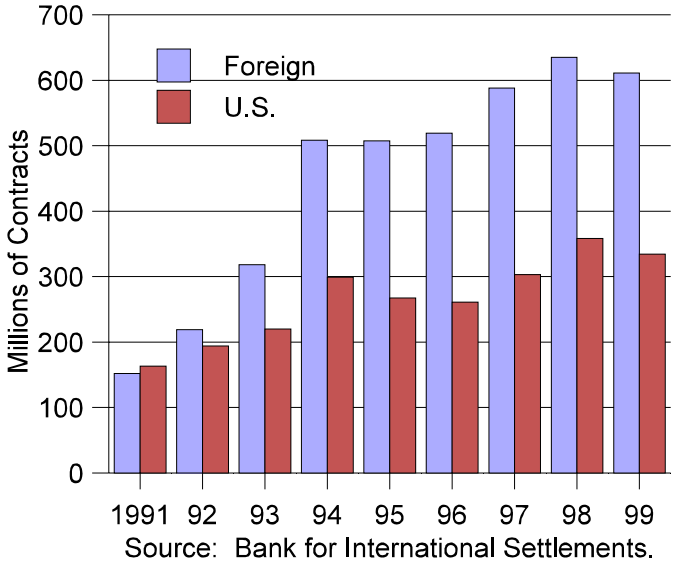
[17] Ibid., p. 34. This would involve amending the securities laws, as well as the CEA.

changes and new contracts for CFTC approval, to maintain an audit trail for all transactions, to collect data on the trading activity positions of large traders, to include outsiders on governing boards and disciplinary committees, and so on. Futures commission merchants (brokers) must register with the CFTC, must meet proficiency and ethical standards, must segregate customers' funds, and must disclose financial information about themselves and certain of their affiliates. In addition, the CFTC has broad authority to intervene in exchange affairs when it determines that the public interest requires it. Such "micro-regulation" does not apply to the OTC markets.

The exchanges for years called for a "level playing field." In addition to competition from the fast-growing OTC markets (see figure 2 above), U.S. exchanges now face competition from foreign futures exchanges, as figure 3 suggests. As electronic trading systems proliferate, and as the trading day lengthens, a foreign futures exchange listing identical contracts and offering a cost advantage could take away significant amounts of the U.S. industry's business.[18]

The 105th Congress considered, but did not enact, legislation that would have permitted the exchanges to operate "professional markets," from which small

**Figure 2. Futures Contracts Traded: U.S. versus Foreign Exchanges, 1991-99**




investors would be excluded, and which would as a result be free of most of the requirements of the CEA.[19] Similar proposals reappear in the Working Group's report, which questions the need for direct regulation of financial futures markets if

[18] Such international "poaching" is not hypothetical: Singapore dominates the market for Japanese stock index futures, and London was the center for contracts based on German government bonds until the recent emergence of a liquid futures market in Germany.

[19] H.R. 467 and S. 257 (105th Congress). See CRS Report 97-413 E, *The Commodity Exchange Act: Legislative History Since 1974*, for analysis of these proposals.

small investors needing protection from fraud are absent and if the possibility for manipulation is small. The report calls for Congress to provide explicit authority for the CFTC to provide regulatory relief for exchange-traded financial futures markets, if it determines that such relief is in the public interest.[20] Again, the line is drawn between financial futures and contracts based on physical commodities where supply is limited (making the creation of artificial shortages possible) and where the futures markets serve a price discovery function, that is, where the futures market price is a benchmark for cash market transactions.

Chairman William Rainer of the CFTC supported these deregulatory initiatives. The CFTC had in progress two rulemaking initiatives that would allow the exchanges to introduce new contracts or to change their rules without prior CFTC approval. To the exchanges, these were crucial changes that would allow them greater flexibility in responding to competition. The chairman stated his intention of moving the CFTC "from being a frontline to an oversight regulator."[21] This meant, basically, that the CFTC would stand back and let the financial derivatives markets evolve in response to market forces, and step in only if something goes wrong. The Working Group takes a similar attitude towards the rapidly-changing OTC market: "[S]uch systems should be allowed to grow, unburdened by a new anticipatory statutory structure that could prove entirely inappropriate to their eventual evolution."[22]

The CFMA includes provisions that allow the futures exchanges to establish less-regulated or unregulated markets in nonagricultural contracts from which small investors would be excluded. As of early 2002, however, a year after passage of the CFMA, the exchanges had not proposed to create such unregulated markets.

It is worth noting that the major costs of exchange trading – margin requirements, marking-to-market (which requires losses to be paid up daily), and clearing fees – are not the results of government regulation but of self-regulation. They are imposed by the industry itself to assure market integrity – to insure, that is, that all contracts are fulfilled. A number of current ventures propose to bring some of these self-regulatory mechanisms to the OTC market, as noted above. However, it is not clear that exchange-trading of swaps or a swaps clearing house will succeed in the marketplace. The major swaps dealers – 10 institutions accounted for 45% of the market at the end of 1998[23] – may resist changes in market structure that could challenge their dominance.

Regarding competition from foreign futures markets, a strong system of regulation may be a marketing advantage. Traders will certainly seek out the lowest

---

[20] *Working Group Report*, p. 21-23.

[21] Remarks of CFTC Chairman William J. Rainer at the 22nd Annual Chicago-Kent college of Law Derivatives and Commodities Law Institute. Chicago, October 28, 1999.

[22] *Working Group Report*, p. 18.

[23] Trend Toward Concentration Accelerated Last year. *Swaps Monitor*, vol. 12, August 2, 1999. p. 1. The top 20 institutions, of which 9 are American, had 64%, up from 50% in 1995.

transaction costs, but their perceptions of market integrity will also influence their choice of trading venues.

It is uncertain how the futures trading would change if financial futures were deregulated. Would major features of exchange system (such as standardized contracts and uniform margin rules) be abandoned, even as the OTC market considers adopting them? An advantage of the OTC market is said to be the flexibility of tailoring the terms of each contract to the customer's individual needs. Customization, however, discourages short-term trading, making it difficult to develop the kind of high-volume liquidity that characterizes the exchange system (and which the OTC market would like to foster).

# Other Regulatory Issues

## Single-Stock Futures and the Shad-Johnson Accord



In November 1999, Senators Gramm and Lugar sent a letter to regulators asking for a study of the feasibility of removing the pre-2000 ban on futures contracts based on individual stocks. The ban dated from the Shad-Johnson accord of 1982, which demarcates SEC and CFTC jurisdiction over stock-based derivatives contracts.[24] The SEC traditionally opposed such futures contracts on the grounds that the leverage available in futures contracts (purchase of a futures contract generally requires a cash outlay of only 3-6 percent of the cash value of the underlying commodity) could lead to excessive price volatility and manipulation of the underlying stocks' price, and that individual stock futures could also serve as a vehicle for illegal insider trading. Nevertheless, the Working Group report states that the members agree that the prohibition against single-stock futures "can be repealed if issues about the integrity of the underlying securities market...are resolved."[25] The report does not call for immediate repeal, however, but urges further study of the issue by the SEC and the CFTC.

The CFMA authorized trading in single-stock futures, although over the course of consideration of the legislation, the instruments came to be known as "security futures." Security futures will be traded on either stock or futures exchange, and the SEC and CFTC will share regulatory jurisdiction. The CFMA states that trading may begin one year after enactment, but as of December 20, 2001, the rules and regulations were not yet in place.

When trading begins, single stock futures can be expected to boost trading volume in futures and in the underlying stocks themselves. Millions of shares are traded daily on the New York Stock Exchange as part of index arbitrage trading

---

[24] Basically, the accord said that futures and options on futures could be traded on futures exchanges, while options on indexes and individual stocks would be traded on securities exchanges under SEC jurisdiction. The SEC retained a right of approval over new stock-based derivatives contracts to be traded on futures exchanges.

[25] *Working Group Report*, p. 32.

strategies – the buying and selling of shares in response to fluctuations in the price of stock index futures and options.

## Conclusion

With their 1999 report, the regulatory agencies in the Working Group put aside their old jurisdictional quarrels and reached a consensus that speculation in financial derivatives by sophisticated institutions and individuals is generally a beneficial activity which government regulation is more likely to hinder than help. The pre-2000 Commodity Exchange Act, with its detailed guidance for market practices and its statutory bias against "excessive" speculation, is viewed by the Working Group's report (and by much of the derivatives industry) as an appropriate model for regulation of traditional agricultural commodity futures, where shortages occur and attempts to corner or squeeze the market have been more or less successful in the past. But the Working Group report viewed the CEA as an obstacle to progress in the new world of derivative finance, and as a competitive disadvantage to American firms competing in an international market.

The 2000 CFMA responds to most of the recommendations in the Working Group's report. The final legislation included a codification of the unregulated status of OTC derivatives markets and gave the CFTC authority to deregulate the financial futures contracts traded on the exchanges.

Earlier in 1999, the Working Group issued a report on hedge funds – unregulated investment pools available only to financial institutions and very wealthy individuals – that recommended the imposition of new disclosure requirements, on the grounds that the failure of a single large speculator with a highly-leveraged position could cause widespread financial disruption.[26] The report noted that the proprietary trading operations of large banks and securities firms pursue the same trading strategies as hedge funds, and pose the same risks. As noted above, a few dozen large banks and brokerages dominate the market for OTC derivatives. Legislation considered but not passed by the 106th Congress would have required the largest hedge funds to file quarterly reports on the size and riskiness of their market positions with the Federal Reserve.[27]

In late 2001, the collapse on Enron Corp., a large unregulated dealer in OTC energy derivatives, raised questions about whether the CFMA left unfinished business. Would imposing disclosure requirements on OTC dealers bring more transparency to the markets? Enron's rapid fall revealed that even sophistcated observers – such as Wall Street analysts and bond raters – had no clear picture of the firm's true financial condition, or even the precise nature of its business activities. While the Enron bankruptcy seems to have had little visible effect on physical cash markets in energy products, in other circumstances the failure of a large derivatives

[26] President's Working Group on Financial Markets. *Hedge Funds, Leverage, and the Lessons of Long-Term Capital Management*. April 1999. 43 p. and appendices.

[27] See CRS Report RS20394, *The Hedge Fund Disclosure Act: Analysis of H.R. 2924.*

dealer might have wide repercussions and do damage to firms not directly involved with the failed dealer.

A reduction of government regulation (or an endorsement of the unregulated status of certain markets, which the CFMA was) need not increase the potential for market instability. In fact, the U.S. financial system has proved to be very robust and resilient in response to a series of financial shocks linked to derivatives – from the 1987 stock market crash to the Long-Term Capital Management hedge fund rescue in 1998, and now the Enron bankruptcy. However, similar events can be expected in the future,[28] and government agencies will have to act, on the basis of whatever information they have in hand, to prevent crises from spreading and spilling over into the real economy. The question in regard to unregulated derivatives dealers is whether regulators and market participants have sufficient information to detect financial crises in advance, or respond to them as they occur.



[28] As the Working Group's hedge fund report (see note 25 supra) puts it: "[M]arket history indicates that even painful lessons recede from memory with time." (p. viii)