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INTEGRITY AND COMPETITION IN CHICAGO'S FUTURES MARKETS

Address to

the Kent College Commodities Law Institute
The Westin Hotel
Chicago, Illinois

October 12, 1989

Joseph A. Grundfest*
Commissioner

*The views expressed herein are those of Commissioner Grundfest and do not necessarily represent those of the Commission, of other Commissioners, or of the Commission's staff.

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It is a distinct privilege to be invited here this afternoon to address the twelfth annual Commodities Law Institute--the premiere annual gathering of commodities law practitioners and regulators. The Commodities Law Institute has grown at a remarkable pace that parallels the explosive interest in futures trading here in the United States and around the world. Indeed, the statistical evidence of that growth is truly mind-boggling. From fewer than 100 participants in 1978, the Institute has mushroomed sixfold to about 600 participants today. Similarly, the overall volume of trading of futures has increased sixfold from 42.8 million contracts in 1977 to 245.9 million contracts in 1988.[1]

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[1]See Futures Industry Association, Annual Report of Volume of Futures Trading (1989). Of this amount, the Chicago Board of Trade accounted for 116.8 million contracts, and the Chicago Mercantile Exchange accounted for 65.7 million contracts. Id. The rapid increase in futures trading is even more apparent when the 1988 statistics are compared to 1970 data, a year in which the Chicago Mercantile Exchange traded approximately 2 million contracts, mostly in pork bellies, and when all futures markets traded only 13.6 million contracts. See id.; At Chicago Boards, Style Differs, N.Y. Times, Feb. 21, 1989, at D1.

Few businesses can claim comparable rates of growth. Thus, regardless of the criticism that has recently been heaped on the Chicago futures markets, it is apparent that futures trading satisfies a substantial market demand and that Chicago's futures markets must be doing something right in response to that demand.

The growth of this Institute and of the industry it serves is not, however, the only statistic worth noting. Extensive historical research in the Institute's files reveals that, despite the thousands of people who have attended the Institute over the years, and despite the hundreds of panelists and speakers who have participated in the Institute's workshops and seminars, never before in history has an SEC Commissioner been invited to deliver a keynote address to this group--and again been seen alive in Washington, D.C. or elsewhere.

So, here I stand before you. No kevlar vest. No riot helmet with flip-down high-impact visor. No shotgun loaded with rock salt. Not even a subpoena. Just a meek, mild mannered member of the United States Securities and Exchange Commission who wants to touch briefly on three topics that I hope won't bore you.

First, I would like to share some thoughts about the U.S. Attorney's investigation of trading practices on the floors of the Chicago futures exchanges. If you haven't dozed off during that discussion, I'd also like to make some observations about the exclusive jurisdiction provisions of the Commodities Exchange Act, their potentially anticompetitive implications, and how those provisions could damage America's ability to compete effectively in the world's capital markets. Finally, if I can keep your interest, I have some comments about the design of the Globex and Aurora systems for electronic after-hours trading, and suggestions for steps that should be considered to assure that electronic trading fulfills its substantial promise.

America Needs Strong Futures Markets

But before addressing these matters, I'd like to say a few words about my perspective on futures markets for those of you who may not be familiar with my previous writings or policy positions. America needs efficient futures markets to provide hedging, risk shifting, and price discovery functions for the larger economy.[2] I believe that strong and liquid futures markets add substantial value to America's financial marketplace. I strongly opposed suggestions that jurisdiction over trading in financial futures be taken away from the CFTC and given to the SEC and, in my spare time, have also sought to explain the

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[2] *Accord* Board of Governors of the Federal Reserve System, Commodity Futures Trading Commission, Securities and Exchange Commission, *A Study of the Effects on the Economy of Trading in Futures and Options* Ch. VI (1984).

analytic errors made by many critics who claimed that the futures markets were to blame for the October 1987 stock market crash.[3]

In all, I think it fair to say that my position towards the futures industry has been far from hostile. Moreover, unlike my colleagues at the CFTC, whose attempts to defend futures trading have occasionally been subject to the criticism in Congress, in the press, and elsewhere that the agency has been captured by the industry it is supposed to regulate,[4] I am fortunate enough to be immune from those criticisms: my policy positions do not promote any institutional self-interest and I have no connections with

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[3]See generally American Enterprise Institute, After the Crash (R. Mackay, ed., 1977) (remarks of Joseph Grundfest); Grundfest, Would More Regulation Prevent Another Black Monday? (July 20, 1988) (speech before the CATO Institute on Policy Reform); Grundfest, Observations on Black Monday (May 12, 1988) (speech before the Federal Reserve Bank of Chicago Conference on Bank Structure and Competition). See also Mr. Grundfest Dissents, Forbes, Dec. 12, 1988, at 138; SEC Votes to Seek New Powers, N.Y. Times, May 27, 1988, at D1; Battling for Market Control, Wash. Post, May 27, 1988, at D1.

[4]See Kriz, Shorter Leash for the Futures Industry?, Nat. J., June 3, 1989, at 1368 (Congress is concerned that the CFTC lacks the "inclination to control the industry at a time when futures trading is growing by leaps and bounds."). See also Senate Panel's Bill Calls for Boosting CFTC's Powers, Wall St. J., Oct. 6, 1989, at C14 (Senator Kerry "levelled hefty criticism at the [CFTC]," stating that "I have serious questions about their ability to regulate."); Futures Prosecutor Assails U.S. Regulators, Investor's Daily, Sept. 13, 1989, at 18 (quoting U.S. Attorney Anton Valukas as suggesting that "federal agencies have been more interested in preserving industries than cleaning them up."); Long-Term Fraud Seen at N.Y. Futures Markets, L.A. Times, May 6, 1989, pt. 4, at 1 (quoting many futures industry professionals as saying that the CFTC "does not keep close enough watch on futures market activities and that its rules are geared more toward catching minor technical violations than major fraud."). By observing that this criticism exists, however, I am not suggesting that it is either warranted or fair.

the futures markets that could support allegations of industry capture. In fact, as a member of the SEC, I have nothing to do with regulating the futures industry;[5] I want to have nothing to do with regulating the futures industry; and I want even less to be captured by the futures industry or to become beholden to it.

For better or worse, my positions are rooted in my training as an economist and my belief in the obvious value that societies obtain from free, honest, and vigorous competition that rewards success on the merits. If my positions are mistaken, they are honestly mistaken, and my errors are my own--they are not a result of the rough and tumble of Chicago, New York, or Washington politics.

But despite my belief in the value of futures trading, I would be less than candid if I suggested that all is peaches and cream in Chicago. While I am a strong supporter of free and honest futures markets, I am not a mindless cheerleader for every position espoused by every member of this industry. In particular, I think it important to observe that some members of this industry have sought to graft the well developed doctrine of Papal infallibility onto the Chicago futures markets and the

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[5]There is an exception to this blanket assertion. The SEC has veto authority over the listing of new stock index futures contracts and can object to such contracts if it finds that (i) the index is settled by means of transfer of the underlying securities, (ii) trading in that index or in any of its components is readily susceptible to manipulation, or (iii) the index is not broadly based. 7 U.S.C. § 2a(iv)(II) (1986). The SEC has never exercised this authority, however.

industry's self-regulatory system.[6] Unfortunately, that graft won't take.

Pollyanish industry supporters who suggest that the futures markets and their participants can, under no circumstances, do any wrong, do the futures markets a grave disservice. Every organization has its flaws. Every market can improve. Unrealistic protestations of perfection serve no one's best interests and ultimately diminish the credibility of those who claim to have achieved perfection. Accordingly, I ask you to view my remarks today as constructive criticism from a disinterested observer who understands a little bit about your industry, a little bit about your regulators, a little bit about politics in Washington, D.C., and even a little bit about politics on the floors of Chicago's self-regulated futures organizations.

America needs strong and efficient futures markets as a central component of its financial services sector as we head into the twenty-first century. We need futures markets that are above reproach. We need futures markets that have broad public confidence. We need futures markets that are big enough to admit

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[6]For example, in the wake of the recent controversy over settlement of soybean future contracts, some floor traders objected to comments by the chairman of Archer Daniels Midland and sought to suspend Archer Daniels from membership on the Chicago Board of Trade. These traders felt that criticism by Archer Daniels violated Rule 504 of the CBT regulations, which states: "It shall be an offense against the Association to engage in any act which may be detrimental to the interest or welfare of the Association." <u>CBT Traders Circulate Petition to Ban ADM from Exchange</u>, J. Commerce, July 17, 1989, at 6A.

their past mistakes and brave enough to assure that those mistakes are not repeated.

With that introduction out of the way, I'd like to turn now to my first topic, the U.S. Attorney's investigation of trading practices on the floor of the Chicago futures exchanges.

The U.S. Attorney's Investigation of the Chicago Futures Markets

When the history of futures trading in the twentieth century is eventually written, the U.S. Attorney's investigation of trading practices in Chicago's futures pits will surely be judged one of the century's most significant events. The importance of the investigation will stretch far beyond the number of traders indicted, the number who plead guilty, the number convicted, and the number ultimately exonerated.

While these details are supremely important to the individuals whose names are batted around before grand juries, and while many current market participants cannot see beyond these immediate concerns because they perceive themselves at risk in the investigation, we must recognize that the individuals caught up in this drama will one day be viewed as little more than footnotes to history. Like Archduke Franz Ferdinand, whose assassination led to World War I, the important fact to future generations is not the death of the Duke (though the Duke might reasonably think that's all that matters), the important fact is the sequence of events ignited by his demise.

In concrete terms, the U.S. Attorney's investigation has already changed the fundamental structure of the nation's futures markets. The markets are now pushing towards electronic order entry systems that can help prevent many, but not all, of the abuses alleged by the U.S. Attorney.[7] The Globex and Aurora systems that were being developed prior to announcement of the investigation have been given even greater impetus as a result of the U.S. Attorney's investigation.[8] Congress has already proposed legislation that would prohibit dual trading in certain markets where it perceives a risk to integrity that outweighs the benefits to liquidity.[9] Congress has also noted its desire to improve the quality of the industry's audit trails[10] and to

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[7]See, e.g., United States General Accounting Office, Futures Markets: Automation Can Enhance Detection of Trade Abuses But Introduces New Risks (1989); Can Computers Keep Traders Honest?, Wall St. J., Aug. 11, 1989, at A12; Can Globex Soothe the Sting?, Institutional Investor, Feb. 1989, at 185; Fraud Investigation Might Bring Futures Pits Into Computer Age, Wall St. J., Jan. 25, 1989, at C1.

[8]Id.

[9]Commodity Futures Improvements Act of 1989, H.2869, § 101, 101st Cong., 1st Sess. (1989) ("Futures Improvement Act"). This provision requires the CFTC to issue regulations prohibiting dual trading in any contract market in which the average daily trading volume is seven thousand or more contracts, and gives the CFTC the authority to prohibit dual trading in other contract markets. The bill passed the House on September 13, 1989 by a vote of 420-0. Recently introduced legislation in the Senate would force the CFTC to suspend dual trading in cases where an exchange cannot demonstrate that its oversight system can detect potential abuse. Senate Panel's Bill Calls for Boosting CFTC's Powers, Wall St. J., Oct. 6, 1989, at C14.

[10]Futures Improvement Act § 201. This provision would require each contract market to maintain "a single record that shall show for each futures or options trade the transaction

(continued...)

expand the use of other enforcement tools, including undercover operations.[11] Further, the markets themselves have undertaken a sweeping re-examination of the effectiveness of their self-governance measures.[12] All in all, if the U.S. Attorney's office disappeared today in a giant windstorm, there is no doubt that many Chicago traders would celebrate as if the Bears had won the Super Bowl and the Cubs had won the World Series both on the same day. Nonetheless, the fact remains that the futures markets will never be the same again.

The point is not that the changes wrought in the wake of the U.S. Attorney's investigation are good or bad. In fact, I am confident that many of you in this audience would be eager to argue a particular side of that question. The point is, instead, that these changes are real and that they have come about only as the result of extraordinary legal and political pressure applied directly to the gut of Chicago's futures markets. Change has also come about only after much denial and defensive posturing

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[10](...continued)
date, time of execution, [and] quantity." Id. § 201(a)(2)(B). The time of execution must be recorded to within one minute within one year of enactment of the legislation, and to within 30 seconds within three years of enactment. Id.

[11]Id. § 203. This provision authorizes the CFTC, in its discretion, to "continue . . . to request the assistance of and cooperate with" other federal agencies in conducting investigations of violations of the Commodity Exchange Act, "including undercover operations by such agencies." Id.

[12]See, e.g., Chicago Exchange Appoints a Panel to Press Reforms, N.Y. Times, Jan. 26, 1989, at 1.

seeking to minimize the implication of the U.S. Attorney's investigation. And therein lies a valuable lesson.

To put this lesson in context, let me first draw a parallel to two other arenas in which self-regulation plays a powerful role: America's securities markets and the United States Congress. I do not for an instant believe that everyone involved in the securities markets is honest. If the point needs proof, my colleagues and I at the SEC spend a good bit of our energy trying to devise more effective strategies to ferret out fraud and abuse in our securities industry. We are also not shy when it comes to criticizing securities market practices and abuse. By the same token, I suspect that all of you are willing to join me in condemning instances of fraud and abuse in the securities industry, and in crafting steps that could be taken to improve the efficiency, competitiveness, and integrity of our securities markets.

Similarly, I do not for an instant believe that every member of Congress, another well-known self-regulatory organization, is above reproach. I also do not believe that Congress has reached such a state of perfection that careful examination and criticism of Congressional action is a wasted effort. Again, I suspect that many of you would join me in reciting a history of Congressional shortcomings or faux pas.

Are members of the futures industry so different from securities industry participants or members of Congress that they should be subject to lesser scrutiny or to lesser criticism? Is there something sainted or holy that descends on mortal men who don badges on the floor of futures exchanges that renders them immune to the temptations that cause securities traders and Congressmen to go astray? The question answers itself. There is no reason to believe that futures traders are any better or any worse than the rest of us. With more than 7,400 futures traders in Chicago alone,[13] it should come as no surprise that there are at least a few scoundrels in the bunch.

With that fact of life fixed firmly in mind, I would hope that the futures markets would welcome aggressive efforts to weed out bad apples who threaten the integrity of the entire market. And by aggressive efforts I mean aggressive efforts, including, as one industry leader put it, "the fear of God."[14]

However, a careful look at the disciplinary sanctions available to self-regulatory organizations raises valuable questions about whether self-regulatory organizations--in the securities markets, futures markets, or elsewhere--really have the ability to inspire divine trepidation, even if they have the good faith and the will. Accordingly, for reasons that I am about to explain, it may always be necessary to supplement aggressive self-regulatory disciplinary mechanisms with effective and aggressive civil and criminal enforcement measures.

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[13]Futures Trading: No Need to Panic, Chi. Tribune, Feb. 24, 1989, at 17.

[14]See The Shoe Drops on Futures Markets, Chi. Tribune, Aug. 4, 1989, at 20 (quoting Leo Melamed, President, Chicago Mercantile Exchange).

The need for coordinated and complementary federal and self-regulatory enforcement has its support in economic literature that has its roots right next door at the University of Chicago. The economic literature explains that, as part of achieving an optimal enforcement level, the two key variables in deterring fraudulent behavior are the probability of detection and the penalty imposed once a violation has been detected.[15]

In order meaningfully to increase the probability of detection, it may well be necessary to use undercover operations of the sort employed by the U.S. Attorney. As a practical matter, unless evidence of certain violations is provided by someone at the scene, it may be extraordinarily difficult or impossible to prove the violation through the examination of audit trails or other extrinsic evidence. In addition, law enforcement agencies have information gathering abilities that are far beyond the capacity of any self-regulatory organization. For example, self-regulatory organizations have no authority to subpoena third parties, to gain access to bank records, to gather information from abroad, or to conduct certain covert information

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[15] See generally Becker, Crime and Punishment: An Economic Approach, 76 J. Pol. Econ. 169 (1968). See also A. Polinsky, An Introduction to Law and Economics 73-84 (1983); R. Posner, Economic Analysis of Law 163-178 (1977); Polinsky & Rubinfeld, A Note on Optimal Public Enforcement With Settlements and Litigation Costs, Stanford Law School, Law and Economics Program, Working Paper No. 29 (Dec. 1986); Polinsky & Shavell, The Optimal Tradeoff Between the Probability and Magnitude of Fines, 69 Amer. Econ. Rev. 880 (1979); Ehrlich, Participation in Illegitimate Activities: An Economic Analysis, in Essays in the Economics of Crime and Punishment 68 (Becker & Landes, eds., 1974); Stigler, The Optimum Enforcement of Laws, 78 J. Pol. Econ. 526 (1970).

gathering activities.[16] Law enforcement agencies can use these tools and thus have an inherent comparative advantage in detecting violations, even when a self-regulatory organization does an honest and vigorous job right up to the limits of its legal authority.

Moreover, if properly used, tactics of the sort employed by the U.S. Attorney can be quite valuable in increasing the precision of the government's enforcement efforts because they can reduce the probability that innocent traders will be falsely accused of violating the law. Further, if properly focused, undercover operations can have a valuable deterrent effect in their own right because violators will have greater reason to be concerned that counterparties may be ready to offer evidence of illegal conduct. Indeed, the SEC has found that undercover operations can be extraordinarily valuable, and we have relied on such operations to obtain convictions in our drive to stamp out penny stock fraud.[17]

Once a violation has been detected, the appropriate level of the penalty becomes the key issue. Under some circumstances, civil fines and penalties of the sort imposed by self-regulatory organizations will lead to suboptimal levels of compliance. The

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[16] See P. Johnson & T. Hazen, Commodities Regulation § 1.22, at 94 (1989) ("P. Johnson & T. Hazen").

[17] In January 1989, nine different defendants were charged with 36 counts of securities fraud, conspiracy, and mail fraud as a result of an undercover FBI investigation involving efforts to manipulate the price of the stock of Protecto Industries, Inc. See SEC Litigation Release No. 12024 (Mar. 8, 1989).

level of compliance may be inadequate because, even if self-regulatory penalties are set at the maximum feasible level, given the probability of detection and the profit that can be earned from a violation, violating the law can still appear to be a reasonable gamble.[18] Criminal penalties may well be appropriate under those circumstances.[19]

Self-regulatory organizations cannot, however, put people in jail.[20] Accordingly, we must recognize the fact that there is a

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[18]See, e.g., Polinsky & Shavell, The Optimal Use of Fines and Imprisonment 24 J. Pub. Econ. 89 (1984). See also Shavell, Criminal Law and the Optimal Use of Nonmonetary Sanctions as a Deterrent, 85 Colum. L. Rev. 6 (Oct. 1985); Posner, An Economic Theory of the Criminal Law, 85 Colum. L. Rev. 1193 (1985). In addition, a recent survey conducted by the Wall Street Journal that was heavily criticized by the futures industry suggested that more than a majority of Chicago's traders believe that current disciplinary systems are an inadequate deterrent to abuse. Violations Are Common at Chicago, Poll Says, Wall St. J., Apr. 18, 1989, at C1. These survey results do not, however, measure the perceived level of deterrence being achieved after recent modifications to self-regulatory disciplinary structures.

[19]Id.

[20]Self-regulatory organizations also cannot enforce the penalties that they mete out in every circumstance. For example, if a self-regulatory organization fines one of its members, the member generally can avoid paying the fine if he or she is willing to sacrifice his or her membership. The self-regulatory organization can of course sell that membership (or, in the case of an exchange, that member's seat) to satisfy the fine, but the effectiveness of that remedy is limited to the value of the membership. Moreover, a violator who sacrifices his membership in one self-regulatory organization in order to avoid paying a fine will not necessarily be barred from participating as a member of other self-regulatory organizations. More fundamentally, because a self-regulatory organization has no power whatsoever over non-members, "the assessment of fines may prove meaningless against non-members . . . since the market has no asset under its control, such as a membership, that can be sold to satisfy the fine." P. Johnson & T. Hazen, § 1.2, at 94.

limit to the degree of compliance that can be attained by any self-regulatory organization--regardless of whether that organization operates in the securities or futures industry. It therefore may not be realistic to expect that the government will defer entirely even to the most aggressive and honest efforts by a self-regulatory organization to police and penalize its own membership.

Consequently, the best strategy for a self-regulatory organization in the long run is, I believe, to recognize the limits inherent in its own structure. Self-regulatory organizations and governmental law enforcement agencies must develop cooperative relationships in which each uses its resources in the area where each has a comparative advantage. Such relationships should not be viewed as an affront to the dignity or sovereignty of self-regulatory organizations because they are not an affront--the simple fact is that even the best self-regulatory organization can only do so much.

If a self-regulatory organization unrealistically overestimates its deterrent and disciplinary capacity, it is setting itself up for a fall. Its failure can then put in motion forces that lead to unnecessary interference in other areas that can be properly governed by self-regulatory organizations. Intelligent self-regulation thus requires an appreciation of the limits of self-regulation.

In that vein, it is useful to observe that news of the U.S. Attorney's investigation prompted two quite different reactions from futures industry sources. One camp practiced the art of denial, seeking to minimize the perception that there might ever have been anything wrong on the floor of any futures market. Like Claude Raines in Casablanca, members of this camp professed shock at the suggestion that there might be gambling in the back room at Rick's.

The other camp said, "Let's get on with it." They were more willing to concede the fact that past investigative and disciplinary measures may have been inadequate and that more aggressive new measures would be necessary. They were disappointed, but not shocked, at the news of gambling in the back room.

But even if you don't accept the substance of my message, and even if you are one of those who believe there was no gambling in the back room, it is important to recognize that many people, including strong supporters of vigorous futures markets, have the perception that not all has been squeaky clean in the pits. Moreover, because Congress is willing to legislate on the perception of a problem, the reality is that perceptions matter--even if you don't think there really is a problem in the futures industry.

Indeed, some participants in the futures markets have been quick to pick up on the "perception" defense. One industry leader has explained that "[w]here there's smoke, there isn't always fire. But where there's smoke, there's always smoke damage."[21] While that may be true for some conflagrations, that explanation slides by an important fact: mortality statistics demonstrate that twice as many people die of smoke inhalation as of burns.[22] So, even if the problem is just smoke, it makes sense to run your operation to avoid generating either smoke or fire because the appearance of impropriety can be as fatal as an actual impropriety.

Competition and Exclusivity

The second topic I would like to address relates to the exclusivity provisions of the Commodity Exchange Act and this industry's loud and oft-repeated belief in the virtues of free market competition. The ethos of this industry is that competition serves efficiency. Competition should be allowed to flourish so that the most efficient trading mechanisms survive and so that customers obtain the best available prices when they buy and sell. "Free markets for free men" is the battle cry here in Chicago,[23] and government intervention has been roundly

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[21] Futures Shock: Fraud Charges Shake the Chicago Exchanges, Bus. Week, Aug. 14, 1989, at 45 (quoting Thomas Donovan, President, Chicago Board of Trade).

[22] In 1985 there were 4,952 fire-related deaths in the United States. Of these fatalities 3,311 (66.9 percent) were the result of smoke inhalation, 1,498 (30.3 percent) were the result of burns, and 143 (2.9 percent) were the result of other causes. Harwood & Hall, What Kills in Fires: Smoke Inhalation or Burns?, Fire J., May/June 1989.

[23] See The War of Two Cities, Time, May 30, 1988, at 42 (describing this phrase as the Chicago Mercantile Exchange's "unofficial motto").

denounced as an unwise infringement on the workings of the market.

The Commodity Exchange Act's exclusivity provision has been criticized as potentially anticompetitive. Because this subject is quite sensitive here in Chicago, I'd like to emphasize that my views on this matter are hardly isolated. They are shared by well-respected jurists and policymakers whose devotion to free markets and to Chicago are above reproach. In particular, Judge Frank Easterbrook of the Seventh Circuit Court of Appeals has, in two recent opinions, commented on litigation by the futures industry designed to prohibit competitors from engaging in new forms of business.[24] Such litigation demonstrates that in some instances--and I quote Judge Easterbrook--"the futures markets' interests may be adverse to investors"[25] because "investors . . . gain from the competition the futures market dislike."[26] Judge Easterbrook further observed that the futures markets may argue that a statute "bars more competition than it does" and that they may litigate "to raise their rivals' cost of doing business, not caring whether they prevail."[27] Judge Easterbrook even went so

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[24] Chicago Mercantile Exchange v. Securities and Exchange Commission, No. 89-1538 (7th Cir., slip op. Aug. 18, 1989) ("IPs Decision"); Board of Trade of the City of Chicago v. Securities and Exchange Commission, No. 89-1084 (7th Cir., slip op., Aug. 17, 1989) ("Delta Options Decision").

[25] IPs Decision, slip op. at 13.

[26] Delta Options Decision, slip op. at 12.

[27] Id. at 13.

far as to suggest that "futures markets will lay claims" designed to prevent the emergence of competing marketplaces and products "only if prevailing would break their rivals' kneecaps--which also could injure investors."[28]

When a jurist as well-respected and as steeped in the virtue of free market competition as Frank Easterbrook talks about efforts to "break rivals' kneecaps," we are obviously in deep water and dealing with a matter that deserves careful attention. The matter that provokes Judge Easterbrook's observation about broken kneecaps is this: the Commodity Exchange Act contains an exclusivity provision that, according to Judge Easterbrook, generally requires that if a financial product possesses significant aspects of a future it must be traded on a futures contract market regulated by the CFTC and cannot be traded anywhere else.[29] If a product is not a future or an option on a future, then it cannot be traded on a futures contract market subject to CFTC regulation.[30] Making matters all the more difficult is the fact that the statute does not define the term

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[28]Id.

[29]IPs Decision, slip op. at 13-14.

[30]Under the Commodity Exchange Act, the CFTC's jurisdiction is limited to transactions involving futures and options on futures. See generally 7 U.S.C. § 2a(ii) (1986). The CFTC thus has no jurisdiction over transactions that do not fit into one of these categories. Furthermore, the Commodity Exchange Act specifically provides that the CFTC has no jurisdiction over transactions involving securities that are not futures contracts. Id. § 2.

"contract for future delivery," and the fact that the pace of innovation in the financial market is such that an increasing number of new products can be expected to challenge the imaginary Maginot Line that separates futures from the rest of the financial world.

If Judge Easterbrook's description of the great regulatory divide is correct, this country's financial markets are in serious trouble. We are in serious trouble because we may have in place a regulatory regime that prevents new financial products from trading in the most efficient marketplace: futures-type products must trade on a CFTC-regulated contract market and non-futures-type products are prohibited from trading on a CFTC-regulated contract market, regardless of efficient market outcomes.

Thus, the futures markets may be irrationally barred from trading new non-futures products even though they may have a comparative advantage in trading that product. Similarly, the banking and securities markets may be barred from trading new futures-like products even though they have a comparative advantage in those markets. Indeed, in some circumstances, it may be impossible for some financial products to trade in the United States at all if those products are deemed to be futures, because the economic rationale for those products is fundamentally inconsistent with the clearinghouse structure of our futures markets.[31]

This artificial distinction is also a sure prescription for lengthy and expensive litigation over the precise location of that imaginary Maginot Line. Moreover, and perhaps most important, this artificial distinction offers all foreign competitors a wonderful opportunity to steal away a significant portion of our financial services industry that we could rightfully retain.

In particular, if the arbitrary product allocation inherent in the exclusivity clause allocates a new financial product to a relatively inefficient domestic futures, securities, or banking market, then foreign competitors may prevail by simply trading the new product in a more suitable environment. Further, if the Commodity Exchange Act's Maginot Line prevents a product from emerging in the U.S. market, foreign markets will probably be glad to step to the plate and satisfy market demand. Also, as we are busy litigating in the courts over whether a product is or is not a future, foreign markets can be busy getting a jump on the

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[31]For example, in the case of commodity-backed bonds, the value of the bonds depends on the bond's interest rate, the value of the commodity, and the issuer-specific risk that there will be a default on the promise to pay. However, in a futures market, the credit of the clearinghouse is substituted for the issuer's credit and there is no issuer-specific risk. Commodity-backed issuer-specific bonds therefore cannot effectively exist in a futures-type marketplace.

product.[32] As many of you in this room know all too well, once liquidity is established on a market, it is very difficult to compete it away to another market.

Fortunately, there is a relatively easy way out of this potentially disastrous box. In principle and in practice, there is no reason why we could not adopt a regime that allows new financial products to trade simultaneously in futures markets, securities markets, and banking markets.[33] When the product trades in the futures market it can be regulated by the CFTC. When it trades in the securities markets it can be regulated by the SEC. When it trades in the banking market, it can be regulated by the relevant banking regulators.

This system of competitive trading with separate regulatory jurisdiction is quite similar to the regime that now governs foreign currency options in which futures, securities, and banking participants are all currently active.[34] The market that prevails in this regime is the market that provides the most

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[32]Futures Outlook: Volume Boom, Market Share Shrinkage, Chi. Sun-Times, Oct. 2, 1989, at 39 (predictions that world-wide futures volume will quintuple by mid-1990's, but that U.S. market share will decline from about 70 percent to about 40 percent.).

[33]See n. 44 infra for a discussion of the issues with the definition of "new financial products."

[34]The SEC and the CFTC share jurisdiction over foreign currency trading. Foreign currency options that are traded on a securities exchange are subject to the jurisdiction of the SEC, 15 U.S.C. § 9(g) (1986), while other foreign currency trading is subject to the jurisdiction of the CFTC. 7 U.S.C. § 2 (1986). See generally Cox & Michael, The Market for Markets: Development of International Securities and Commodities Trading, 36 Cath. L. Rev. 833, 839 n.31 (1987).

efficient environment for trading the product--not the market that has been arbitrarily assigned the product as a result of legislative fiat.

Some futures industry advocates might object to this proposal by claiming that I have misdiagnosed the problem. They might claim the exclusivity provision gives rise to no futures industry monopoly because anyone can open a futures contract market. In support of this position, defenders of government-imposed market allocations schemes might observe that several stock exchanges have formed their own futures markets.[35] Futures industry advocates might then argue that all these new entrants can simply trade their own futures product on their own futures market instead of on their stock exchange and the interests of competition would be served.[36] Thus, it might be argued that the exclusivity provision of the Commodity Exchange Act really presents no barrier to entry and imposes no burden on competition.

The problem with this response, however, is that it overlooks the realities of today's marketplace as well as many of the most powerful lessons of economics. As economists have long

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[35]For example, Amex Commodities Corp. is a unit of the American Stock Exchange, and the Philadelphia Board of Trade was established by the Philadelphia Stock Exchange. More recently, the Pacific Stock Exchange announced its plan to set up a futures market to trade computer chips. See Chips on a New Block, Time, June 12, 1989, at 51; Market for DRAM Futures Planned, Fin. Times, May 31, 1989, at 1.

[36]See IPs May Rise Again on Amex, Phlx Futures Exchanges, Wall St. Letter, Aug. 28, 1989, at 3.

known, competition depends on much more than the simple number of firms doing business in a market. Competition relies also on innovation, new methods of trading, new methods of marketing, and new techniques for product distribution.[37] As long as all products with any "futures" characteristics are required to trade on a futures contract market, there is no opportunity for experimentation or innovation with other trading or marketing mechanisms.

The CFTC's recent efforts to fit regulation of hybrid instruments--instruments such as debt obligations whose interest rate is tied to the change in price of a specific commodity, such as gold or oil--into the rubric of the Commodity Exchange Act illustrate this point perfectly. As debt instruments, hybrid instruments represent an obligation of a particular issuer, and as such they are ordinarily traded on securities exchanges.[38] However, because hybrid instruments have "certain elements of futures or commodity options contracts," the CFTC proposed in 1987 and again in 1989 to regulate them as futures products.[39] Regulation of these instruments as futures, however, would have

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[37] See, e.g., Edwards, The Future Financial Structure: Fears and Policies, in American Enterprise Institute, Restructuring Banking & Financial Services in America 113 (Haraf & Kushmeider, eds., 1988).

[38] For example, oil-indexed debentures issued by Standard Oil Company trade on the New York Stock Exchange. Breeding Hybrids on Wall Street, Am. Lawyer, Oct. 1987, at 16.

[39] 52 Fed. Reg. 47,022, 47,022 (1987); 54 Fed. Reg. 1128 (1989).

precluded them from trading on securities exchanges or from being issued by banks. As a result, participants in the market for hybrid instruments, as well as the federal banking regulators and the SEC, urged the CFTC to revise its proposal, stating that regulation of hybrid products under the federal banking and securities laws had "promoted capital formation [and] fostered innovation and product diversity," and asserting that mandatory regulation of such instruments by the CFTC would "diminish the market benefits that result from hybrid products without promoting the purposes of the [Commodity Exchange Act.]"[40] Ultimately, the CFTC decided that it would not assert jurisdiction over many hybrid instruments,[41] but only after going through much angst over the problem and only after all of the interested parties had expended a great deal of resources arguing about which agency should properly have jurisdiction over hybrid instruments.

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[40]Letter from Jonathan G. Katz, Secretary, Securities and Exchange Commission, to Jean A. Webb, Secretary, Commodity Futures Trading Commission (Aug. 19, 1988). See generally SEC Urges CFTC to Withdraw Plan for Regulating Hybrid Instruments, Sec. Week, June 26, 1989, at 1; Fed Sharply Criticizes CFTC Plan for Regulating Hybrid Products, Sec. Week, June 5, 1989, at 6; OCC Urges CFTC to Broaden Bank Product Exemption in Hybrid Instruments Rule, BNA Banking Rep., May 1, 1989, at 951; FHLBB, Others, Ask CFTC to Modify Its Proposal on Hybrid Instruments, BNA Banking Rep., Mar. 13, 1989, at 627.

[41]The CFTC termed its decision not to assert jurisdiction an "exemption" under the Commodity Exchange Act. 54 Fed. Reg. 30,684 (1989). In order to qualify for this "exemption," among other things, an instrument must not be marketed as a futures contract or a commodity option, and the value of its futures component must be no greater than 40% of the issue price of the instrument. Id.

Some futures industry advocates might also object to a system of competitive trading with parallel regulatory jurisdiction for new instruments because it overlooks the legitimate public policy considerations that caused Congress to adopt the Commodity Exchange Act's exclusivity provision. The legitimate public policy purposes of the statute's exclusivity provisions are, however, well understood and monopoly grants are not among them. As early as 1921, Congress recognized the dangers of fraud associated with bucket-shops and other forms of off-exchange trading.[42] To prevent the problems associated with fraudulent bucket shop operations and other forms of fraud, Congress prohibited all off-exchange futures trading and granted the CFTC exclusive oversight authority over the futures contract markets. Exclusive CFTC jurisdiction also serves several legitimate purposes. It eliminates the danger of multiple regulation by agencies claiming jurisdiction over futures products and their underlying commodities, and assures that the

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[42] 1 P. Johnson & T. Hazen, § 2.00-2.04; Buchoversky, The Future of Leverage Contract Trading Under the Futures Trading Act of 1986, 37 Amer. Univ. L. Rev. 157, 168 (1987) ("The Act's legislative history reveals that the exchange trading requirement was enacted in response to congressional concerns regarding the susceptibility of the market to excessive speculation, fraudulent practices by brokers and exchanges, and other abuses. . . . Practices found particularly offensive by government officials included fraud in handling orders, bucketing of orders, wash sales, cross trades, and accommodation trades." (footnote omitted).

agency with oversight responsibility has an incentive to develop particularized expertise regarding the futures industry.[43]

In order to achieve these legitimate goals, however, it is not necessary to provide futures contract markets with a monopoly over futures trading. Believe it or not, banking and securities regulators are probably as capable as the CFTC of preventing off-exchange, bucket-shop operations, and other types of fraud. Moreover, if banks and securities markets are allowed to trade new instruments with futures-like characteristics, no duplicative regulatory burdens would be placed on the futures exchanges and the CFTC's ability to regulate futures trading on its contract markets would not diminish one whit. The exclusivity provisions of the Commodity Exchange Act therefore appear to be overbroad: by establishing monopoly restrictions they introduce competitive distortions that are unnecessary to prevent fraud or to rationalize regulatory burdens.

Thus, rather than have a law that says we'll never know which market is better because, if a new instrument is a future it must trade on a futures contract market, and if it's not a future it can't trade on a futures contract market, why don't we let the market decide? Why don't we move towards an environment in which new financial instruments can be traded simultaneously in futures, securities, and banking markets--subject, of course, to stringent antifraud requirements--and let the forces of

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[43] 1 P. Johnson & T. Hazen § 4.43 (1989).

competition determine which market is most efficient and desirable?

Under a regime of competitive trading with separate regulatory jurisdiction, success or failure in the marketplace would be determined by competition on the merits.[44] If a new

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[44]As a practical matter, it will likely be easier to implement a regime of competitive trading with separate jurisdiction than to continue under the current system which requires that judges and regulators engage in the metaphysical exercise of determining whether a new instrument is or is not a "contract for future delivery." As Judge Easterbrook puts it, this problem is like choosing whether "tetrahedrons belong in square or round holes." IPs Decision, slip op. at 2. In contrast, under a regime of competitive trading with separate jurisdiction, the central jurisdictional issue is whether an instrument is a "new" instrument--an issue that can be resolved by reference to instruments that exist and are broadly traded in particular markets as of a specific date of enactment. While answering this question might not always be easy, it will often be simpler than pounding tetrahedrons into square or round holes.

In addition, a regulatory regime that relies on competitive trading with separate jurisdiction, as applied only to new instruments, can be structured to protect the vested interest that futures markets have in trading traditional futures products while simultaneously respecting the vested interest that securities markets have in traditional securities products. Thus, the New York Stock Exchange could not start trading equity index futures and the Chicago futures markets could not start trading stock in IBM. New applications of existing instruments could also continue to be allocated to current markets. Thus, a futures contract on bananas could not be traded on a stock exchange simply because we have no bananas futures today. Similarly, shares of stock in new companies could not be listed on futures exchanges simply because those companies' shares do not trade today. Further, existing compromises over product prohibitions could be honored. Thus, futures trading on individual stocks would not be permitted and prohibitions on off-exchange trading of contracts for future delivery would be preserved.

Jurisdictionally, the SEC would gain no authority over the CME or CBT, and the CFTC would gain no jurisdiction over the NYSE, NASD, or AMEX. Instead, the jurisdictional scope of the regulatory agencies would be determined by flexible market

(continued...)

product trades more efficiently in the futures markets, the futures markets will dominate trading for the new instrument. If a new product trades more efficiently in the securities markets, the securities markets will dominate trading. If some customers prefer futures markets and others prefer securities markets, then business may be split between futures and securities markets. Decisions will be made where they are made best--in the markets, not in the courts or in agency chambers.

This is the free market solution to a serious problem of international competitiveness and market efficiency that threatens our financial services industry as we head into the twenty-first century. We cannot afford to let the future of our financial services industry depend on whether one judge or another decides that a novel financial instrument is or is not a futures contract--particularly when the markets provide a better arena for allocating products and when powerful competitive forces may be crafting more efficient and rational solutions abroad.[45]

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[44](...continued) forces, not wooden regulatory definitions, because the regulators with the most efficient markets would be the regulators that get the most business.

[45]Competitive trading with separate regulatory jurisdiction is also consistent with the view that competition among regulatory agencies is beneficial because it promotes experimentation and efficiency in regulatory practice. <u>See, e.g.</u>, Fischel, <u>Regulatory Conflict and Entry Regulation of New Futures Contracts</u>, 59 J. Bus. 585 (1986); Anderson, <u>The Regulation of Futures Contracts Innovations in the United States</u>, 4 J. Futures Markets 297 (1984). Indeed, Chicago's futures markets have long favored competition among regulators and have (continued...)

In sum, a regulatory approach that relies on competitive trading with separate regulatory jurisdiction is perfectly consistent with the logic and philosophy long promoted by the Chicago futures markets. It is a Chicago solution to a Chicago problem. It is a solution that promotes domestic competition, positions our markets well against foreign competition, fosters innovation, and serves the best interests of America's and the world's investors.

Chicago's futures markets can, if they like, oppose any measure that threatens their anticompetitive, monopoly position under the Commodity Exchange Act's exclusivity provision. However, if the Chicago markets oppose such pro-competitive measures, they should recognize that the sincerity of their commitment to principles of free trade and competition will be properly subject to serious question. Moreover, those questions could be raised in situations that the futures markets might find uncomfortable or even embarrassing, and it might be hard to listen to the motto "free markets for free men" without wondering which markets and which men Chicago is talking about.

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[45](...continued) used this rationale to argue that the CFTC's exclusive jurisdiction over financial futures should not be transferred to the SEC. See, e.g., Melamed, Different Products Need Different Rules, N.Y. Times, Aug. 27, 1989, at F2. See also Fischel, Should One Agency Regulate Financial Markets? in Robert J. Barro, et al., Black Monday and the Future of Financial Markets 113 (1989). Contra Merge the Market Watchdogs, N.Y. Times, Aug. 27, 1989, at F2. By the same logic, the Chicago markets should support the proposal for competitive trading with separate regulatory jurisdiction because it would allow regulatory competition to occur head-on across a wider range of products.

Globex-Aurora

The last subject I want to address, and I will do it briefly, regards the design of the Globex and Aurora systems for electronic after-hours futures trading. The Aurora system relies on a system of "icons" in which traders can select the counterparty with whom they do business at prevailing market prices.[46] Trading on the Aurora system is thus designed to preserve current floor dynamics in a Nintendo-like setting where trades "hit" other traders based on whatever criteria they wish. Globex, in contrast, relies on a system of price and time priority in which the trader who makes the best price first gets the business ahead of others who came to the market later.[47] Globex thus involves less eye-hand coordination and relies more on a logical and principled system of matching buyers and sellers that can be a dramatic improvement over any trading system available in the securities or futures markets today.

While this distinction may seem like a small detail to some, it is a critical difference with substantial potential implications for the efficiency, integrity, and fairness of electronic futures trading. Under the Globex system, traders

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[46]See Exchanges Link Trades After-Hours, Wall St. J., May 30, 1989, at C1; Future Shock Is Rattling the Futures Pits, Bus. Wk., Apr. 17, 1989, at 93; Computers for the Futures Pits, N.Y. Times, Feb. 13, 1989, at 19; Board of Trade Plans Computerized Trading, N.Y. Times, Feb. 10, 1989, at 34.

[47]See id.; The Computer That Ate Chicago, Institutional Investor, Feb. 1989, at 181.

have a strong incentive to offer the best available prices because, if they take the risk in making the best price first, they will then be guaranteed to get the business that follows at that price. In contrast, under the Aurora system, the trader that first makes the best price might not get <u>any</u> of the market because counterparties could simply decide to do business with someone else. For example, they might prefer a "buddy" or a fellow member of a "trading group".[48] The Globex system thus has a significant advantage in stimulating superior prices and promoting competition on the merits.

Further, if part of the incentive for the "icon" design of Aurora is to protect the interests of smaller locals,[49] the Aurora design could well backfire. Smaller locals will often be unable to offer transactions of the size that larger market participants desire. Rather than split an order among several smaller "icons" on a screen, a large trader may prefer to trade solely with other large traders who are willing to do business in adequate size. Thus, even if smaller locals were the first to make the best markets, they would find themselves shut out of the market because they would not be protected by the price and time

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[48]<u>See</u> <u>Technology Wars Ravage Chicago</u>, Fin. Times, Mar. 21, 1989, at 30 ("[T]hose who have seen Aurora are questioning the fairness of the system. The floor broker chooses which trader, represented by an image on the screen, he hits the bid or lifts the offer from--rather too close a replication of the way the pits work today.").

[49]<u>Stodgy CBT's Risky Bet: Old Ways to Return</u>, Crain's Chi. Bus., May 15, 1989, at 1.

priority offered by Globex. Therefore, if one purpose of the Aurora system is to design an electronic screen that preserves current floor relationships and practices, Aurora's design may ironically do more to harm many of the locals it is intended to protect than the competing Globex system with its time and price priority.

The Aurora system also raises questions about the opportunity to engage in illegal electronic trading. With the Aurora system traders could, over the telephone, reach certain illegal understandings about their trades and then be sure that they could effect those understandings because Aurora permits them to select their counterparties. In contrast, Globex traders will not be able to pick their counterparties because of Globex's price-time priority rules. Globex therefore will make it far more difficult to engage in certain forms of illegal trading and offers greater assurances of integrity in the electronic marketplace.

Thus, whatever the benefits of an "icon"-based system it is clear that the drawbacks of an "icon"-based system are also substantial. Relevant markets and regulators should think more than twice before endorsing an "icon"-based system as proposed for Aurora, especially when there is available a more efficient, competitive and equitable system that offers greater assurances of market integrity.

Conclusion

Chicago's futures markets have much to celebrate, and I am confident that with wise and realistic leadership they will be able to survive and thrive despite many of the problems that plague the industry today. Tomorrow's futures markets will, however, look quite different from today's. We should not lament that fact. We should celebrate it. With just a bit of wisdom, just a bit of integrity, and just a bit of a willingness to act on a belief in the benefits of competition, this industry can craft for itself a future far brighter than its past. Indeed, I am optimistic about this industry's ability to rise to the challenge and to fulfill the substantial promise that the twenty-first century holds in store for us all, and I look forward to your rising to meet that challenge.