Commentary: Latest Adventures in Derivatives Reform

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On Friday, the Securities and Exchange Commission (SEC) and Commodities Futures Trading Commission (CFTC) issued their Joint Report on the Harmonization of Regulation. The Report deals with a number of technical issues, such as including securities futures in margin accounts, but fails to deal with the primary reason harmonization of the agencies is important to the national economy.

The only reason the SEC and CFTC need to harmonize regulation is to tame the unruly derivatives markets. Proper regulation of derivatives is essential if we are to avoid another severe financial crisis in the near future.

Prior to 2000, the SEC and CFTC conducted a turf war over derivatives regulation. There was no disagreement among the agencies that the CFTC should regulate contracts for future delivery of commodities, such as corn, oil and gold. Nor was there any doubt that the SEC should regulate stocks and bonds. This agreed jurisdictional boundary also extended into the world of derivatives. So, the SEC agreed that options on wheat futures should be regulated by the CFTC, and the CFTC acknowledged that the SEC should regulate options on stocks and bonds. The border dispute emerged over futures on the S&P 500 Index. The CFTC viewed its jurisdiction as encompassing futures of all sorts, including futures on financial instruments, a position that led to a series of inter-agency boundary disputes.

A future is a promise to deliver something at a later time for an agreed price. As is the case with any regulatory definition, words never mean exactly what they seem. Strictly speaking, a trade is a promise to deliver a security at an agreed upon price three days later, but no one thinks that clearing procedures should be regulated as futures. Similarly, the CFTC has long agreed that a farmer's promise to deliver wheat to a cereal manufacturer in a few months, called a forward, is not a future, even if the wheat is still in the ground at the time the contract is formed.

The promise to deliver evolves into a future when it becomes tradable in an anonymous market. In short, the definition of "future" is informed by its marketability. Civilized societies have recognized the need to regulate markets for millennia. The most primitive medieval lords knew that markets, although essential for economic well-being, were sources of revolution and all sorts of civil unrest and therefore bore watching, generally by armed soldiers stationed on their perimeters.

In 2000, Congress, largely at the behest of Alan Greenspan, decided that the best way to settle this turf war was to place a large portion of derivatives outside

anyone's regulation. This rejection of the history of Western Civilization's market regulation was consecrated in the Commodity Futures Modernization Act of 2000 (CFMA).

The CFMA settled the dispute over futures on securities indices by granting regulation of "broad-based" securities indices to the CFTC. Regulation of "narrow-based" securities indices and single stock futures, which were prohibited under the "Shad-Johnson Accord," an earlier 1982 peace treaty between the SEC and CFTC, was now to be jointly regulated by both agencies. Most importantly, swaps were not to be regulated by either agency. Shortly thereafter, the credit default swap was born, and the rest is history.

In light of the historical conflict between the two agencies, and the resulting ill-fated attempt to settle it by taking everyone's toys away and sending the quarreling children to their corners, a final resolution is perceived as an important first step in re-regulating the derivatives markets.

The Group of Thirty, the think tank whose suggestions formed the basis of Obama's proposed financial reforms, thought the best way to resolve this conflict would be to merge the CFTC into the SEC. I thought President Obama's appointment of Mary Schapiro as chairperson of the SEC was intended to smooth this merger, since Ms. Schapiro had previously served as chairperson of the CFTC.

Instead, the President's reform package called on the SEC and CFTC to propose ways that their regulation of the markets could be harmonized. The reason for this approach is purely political. Congressional oversight of the CFTC is vested in the Agriculture Committee, while Finance oversees the SEC. The Agriculture Commission is the most likely loser in a merger of the two agencies.

It seems we are living in the age of convergence. The G-20 is seeking to harmonize financial services regulation among its national members. Similarly, politics being the art of the possible, the President asked the SEC and CFTC to determine how their regulation might be harmonized. In response, the SEC and CFTC held roundtables last month to discuss convergence. Now, we have the inevitable report.

Convergence is intended to impose similar regulatory regimes among different regulators by causing the regulators to agree to take the same approach to similar regulatory problems. If successful, the regulated will have no incentive to select a certain jurisdiction based on its less-aggressive regulation, a behavior called "regulatory arbitrage."

The problem with convergence, whether among nations or warring agencies, is the same. Cultural differences reflect the experiences and shared values of nations. These cultural differences cause separate nations to approach the same social problem differently. So also, the CFTC experience is based on the regulation of

commodities. It naturally approaches the regulation of its markets differently that the SEC, which views markets primarily as part of the capital formation process.

The CFTC's regulatory philosophy targets market abuses largely by limiting the size of positions that any one person can take in futures contracts. The CFTC's regulatory scheme therefore requires futures to be traded in designated contract markets so that it can keep an eye on position sizes and monitor attempts to manipulate market prices through such techniques as "corners" and "squeezes."

In contrast, the SEC is concerned primarily with disclosure as the antidote to just about all market ills. Insider trading, which allows privileged insiders to profit from a lack of disclosure, is prohibited in securities, but not in commodities futures. Insider trading causes investors to doubt the integrity of securities markets, which diminishes their willingness to invest in new issuances. In contrast, wheat, corn and gold are fungible commodities. Disclosure about their attributes is readily obtainable in encyclopedias, and insider trading is not likely to cause cereal manufacturers to avoid buying wheat futures. We might, as a people, still wish to discourage insider trading in commodities futures as a matter of fairness, but the economic imperative is not as clear.

So, which regulatory approach best accomplishes the policy objectives of derivatives regulation? As a securities lawyer, I have a natural affection for regulation by the SEC. However, it seems that the CFTC's regulatory philosophy is best suited to the regulation of financial derivatives.

After all, it was the CFTC that first sounded the alarm regarding the growth of the swaps market. The CFMA was largely intended to prevent the CFTC from engaging in attempts to control this monster. The SEC was on the side of those who thought the market did not require regulation.

Moreover, most economists think of derivatives as risk-shifting devices. That role also suggests that derivatives are not really part of the capital raising process. Instead, they are more like futures, which primarily function to enable manufacturers to guarantee a stable source of supply and predictable prices for commodities. The experience of the CFTC in the regulation of futures is more relevant for the regulation of swaps and most other derivatives than the SEC's capital raising regulatory goals. The CFTC, after all, is not about encouraging more wheat production.

This is not meant to imply that the CFTC should regulate the market for financial derivatives. The CFTC's intrusion into financial markets has not been successful, and it is not appropriate for the House Agriculture Committee to assume a role properly allocated to the Finance Committee.

Instead, the SEC's regulation of markets should be strengthened. One of the primary ways that could be accomplished is for the SEC to adopt important

elements of the CFTC's regulatory approach. I am not the first to suggest that the SEC would be a stronger agency if market regulation became its primary regulatory goal and capital raising became relatively less important.