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Examination of congressional misunderstanding of the role of speculation in futures markets

Mary Sue Brenner

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AN EXAMINATION OF CONGRESSIONAL MISUNDERSTANDING
OF THE ROLE OF SPECULATION IN FUTURES MARKETS

By
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B.A., Montana State University, 1980

Presented in partial fulfillment of the requirements for the degree of
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JUNE 11, 1982
Date
The understanding of futures markets by the general public and the government is paradoxical. Futures markets are economic markets which benefit the public through stabilized prices for agricultural products reflected in the cost for groceries. Yet in this country, futures markets have been subject to governmental and public criticism since their beginning in the mid-1880s. The problem is misunderstanding. Futures markets are not widely understood by the public or government officials. Indeed, a committee of the House of Representatives once labeled futures markets as esoteric in nature. Part of this misunderstanding stems from misconceptions held by Congress of the role of futures market participants, particularly the role of the speculator.

Congress has attempted to define its relationship with futures markets since 1922 when the first legislation regulating futures markets was passed. This writer has examined the legislation passed since 1922 and numerous congressional hearings to determine past and present congressional perceptions of speculators in futures markets.

The findings of this research support the premise that the role of the speculator in futures markets is misunderstood by Congress. Evidence of the problem is exhibited in the language of the law and in subsequent hearings to modify the law.

This writer concludes with suggestions to correct this misunderstanding. The suggestions are offered as possible means to aid Congress in understanding the role of the speculator. If Congress expands its knowledge of the role of the speculator, a more complete understanding of the uniqueness of futures markets will result. More effective and sound regulatory policies might be passed and, consequently, futures markets will continue as a vital cog in the United States economy. The general public will be the ultimate beneficiaries.
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Chapter 1

BASICS OF THE FUTURES MARKETS

Futures markets. What are they? A decided mystique surrounds futures markets because such a small proportion of people understand their function. The idea of futures trading can be traced to twelfth century medieval fairs in France and England. In the United States, futures markets developed in the midnineteenth century. The essence of futures markets did not develop overnight, nor can any individual be credited with their conception. Their unfoldment is rooted in commerce along with the maturation of cash markets.

Elements of Futures Trading

Futures markets serve as a medium for contracts of future spot transactions to be purchased or sold. The contracts for the future transactions are in assets or services and the markets serve as disseminating price information of the particular contracts.

Contracts traded in futures markets provide for agreement today to deliver (a short position), or take delivery of (a long position), a specified grade and quantity of an asset at a specified location(s) and time(s) in the future at a price negotiated and stipulated through auction agreements (Burns, 1979:32).

The contracts to be exchanged in futures markets are governed by market forces. These same market forces rule the liquidity of futures markets. Legally, futures contracts must be traded upon an approved futures exchange. There are eleven futures exchanges in the United States. Thomas Hieronymus outlined the essential elements of
futures trading: "contracts made for purposes other than exchange of title (although not clearly recognized), deposit of funds to guarantee performance, restriction of trade to members, and standardized contract terms" (Hieronymus, 1971:74).

In the United States, futures exchanges transposed contracts on storable commodities such as grain, corn, and soybeans. In 1964 the Chicago Mercantile Exchange proffered the maiden contract on a nonstorable commodity—live cattle. The live cattle contract proved to be prosperous and developed into other nonstorable commodity contracts. The next reasonable step was contracts on financial instruments. Why? Money is a commodity. Money can be stored and exchanged. The price of money is reflected on the foreign currency market for each country's present rate of exchange. This rate simulates the purchasing power of the country's currency relative to other countries.

Leo Melamed is known as the father of financial futures because he bolstered the foreign currency futures market. This became the first financial future contract. It was listed by the Chicago Mercantile Exchange in 1972.

The succeeding gradation was the development of interest rate futures contracts. The first interest rate future contract was the Government National Mortgage Association (GNMA) contract in 1975 and the adjoining 90-day treasury bill contract in 1976. Since then, futures contracts have been launched in United States treasury bonds, one-year treasury bills, and four-year treasury notes. These were immensely successful and today the market for treasury bonds enjoys
the greatest open interest of all the futures contracts. Corn and soybean contracts are now second and third, respectively.

Financial futures now account for 30 percent of all futures trading volume (Byrne, 1982). This is remarkable when one considers that the first financial futures was contracted in 1972. Futures contracts based on private securities such as commercial paper and certificates of deposits were developed in the late 1970s and early 1980s. These contracts have not obtained as great a volume as government securities contracts. This situation is expected to change as more institutional investors use the financial futures contracts.

Agricultural commodities futures were developed by commercial buyers and sellers of the commodity to hedge their price risk from market influences. Financial futures provide a vehicle for institutions and security dealers in financial markets to hedge their risks from interest rate fluctuations. The succeeding futures contract on equity-based futures is a component of this evolutionary chain of risk avoidance contracts. The issuing, buying, and selling of stocks by individuals, corporations, and investment bankers is exposed to market risk. Interest rate volatility is a factor of market risk. Stock index contracts and contracts founded on individual stocks can be put to use to offset this risk in the cash market for stocks. A stock index future tied to the Value Line index was listed by the Kansas City Board of Trade in February 1982. Open interest in the contract has been superior to previous open interest levels of newly listed contracts. A contract usually requires two years to exhibit market maturity.
Applications pending before the Commodity Futures Trading Commission are futures contracts such as those tied to the producer price index, Dow Jones Stock Index, and Standard and Poor's 500 composite stock index, prime rate, and money supply. Financial instrument contracts are anticipated to maintain their immense growth in volume and open interest because equity and money markets will perpetually be besieged by uncertainty and changeableness.

Market Participants

Who are the participants in futures markets? There are two types: hedgers and speculators. A hedger produces or purchases a commodity in the cash market. Influences beyond the hedger's control project uncertainty into levels of prices paid for the physical commodity. Cash and futures prices tend to move in the same direction because they react to the same economic influences. Because they move in tandem, a hedger can offset his risk in the cash market by taking an equal but opposite position in the futures market. The difference between the cash market price and the futures market price is addressed the basis. The concept of a hedge is to cover one's position in the cash market.

The risk for the processor or user of commodities is the reverse, that the supply situation will tighten to a point that rising prices will add to his costs and impair his profits. The producer or owner of commodities will use a selling, short hedge as protection against declining values. The user of commodities will use a buying, long hedge in futures contracts to protect against rising prices (Commodity Training Manual, 1980:9).

The rising prices referred to are prices for commodities in the cash market.
Speculators do not materially possess a specific interest in the physical commodities but observe the movement between cash and futures prices. A speculator assesses price movement and risks venture capital for the sake of profit. Speculators buy or sell futures contracts in response to their estimation of price movement, direction, and swing.

To the extent that the speculative holding of inventories is (on balance) successful, it performs a useful economic function by reducing swings in commodity prices. The smaller swings in commodity prices foster expectations of greater long-run price stability. In turn, the reduction of price risk fosters an increase of commercial demand for inventories [which] directly promotes larger commercial demand. ... ... This encourages production, which also tends to enhance market liquidity (Burns, 1979: 22).

The costs to speculators are transaction costs and the cost of carrying an open interest.

It is possible to group speculators by trading habits. Four groups are generally recognized: (1) position traders, (2) day traders, (3) scalpers, and (4) spreaders. A position trader initiates a trade and holds it through days, weeks, and even months. Position trading is most widely utilized by public commodity traders and professional traders who are members of an exchange. Day traders are those who maintain a market position for the course of a day and rarely hold it overnight. Day traders often execute their transactions in the trading pits in person. Scalpers are professional traders trafficking in daily price fluctuations. "His technique is to trade in minimum fluctuations, taking small profits and consequently, small losses, on heavy volume of trades" (Commodity Trading Manual, 1980:104). As a result of scalpers' willingness to purchase at the asking price and sell at the bid price,
this group contributes the largest portion of total speculative liquidity. A spreader is a speculator who distinguishes relationships between or among prices of the same future on different markets or prices of dissimilar contracts. When perchance price relationships considered to be normal because of supply-demand conditions become distorted, a spreader will command two simultaneous positions. Through a spreader's reaction to distortions, prices realign to their normal relationships.

A small capital outlay of 5 to 15 percent of the total value of a contract must be put up as margin. Margin in this sense is a good faith performance deposit and is not to be confused with the buying of stocks on margin. A trader is credited with the price movement on the full value of the contract. This is the essence of leverage. For example, a 90-day treasury bill contract is in denominations of $1,000,000 per contract, but the margin requirements to secure the contract is approximately $2,000. Leverage can work for or against one's position. If the trader's prediction of price movement proves to be incorrect, he receives a margin call to bring his account to the required level. Margins can be eroded in a day of trading and the trader must honor each margin call or face having his interest sold by the clearing corporation in the market.

The clearing corporation of an exchange acts as an intermediary between the buyer and seller. It becomes the opposite party to each contract bought or sold. This allows parties to the transaction to remain anonymous. The success of this system can be gauged by the number of contract defaults. The Chicago Board of Trade Clearing
Corporation is proud that, in its 54-year establishment, no customer has ever lost a dime owing to contract default.

Futures trading is a zero sum game. The cash value of all futures contracts is zero because transactions are accounted for by the mark-to-market activity. All profit and loss positions are settled daily, thus each contract has a value of zero at the end of a trading day.

Prices are disseminated from trading floors through the Associated Press, United Press International, Commodity News Service, U.S. Department of Agriculture, and Dow Jones publications such as the Wall Street Journal and Barron's. This results in futures prices being inexpensive and easy to obtain. The information is opportune and universal.
Chapter 2
THE ROLE OF THE SPECULATOR

What is Speculation?

What creates speculation? Opinions. These conclusions are developed through the trading floor's function as a forum for opinions. As one author expressed it, information falls onto the trading floor and flows through like tomatoes into a Cuisinart (Katz, 1981).

Trading on the floor is conducted in pits or rings. Each futures contract has a designated pit where traders congregate at the opening bell. Buying and selling is done by open outcry in the pit. Traders enter the pit with their beliefs based on technical charts, fundamentals of supply and demand, or instinct. These beliefs are discussed and churned about by the traders. The perceptions are then expressed in buying and selling actions.

The opinions are important because they shape the pricing mechanism for futures markets. Speculators need to understand cash and futures price relationships before they can trade. The more accurate a speculator is in forecasting prices and reacting to new information skillfully, the greater the speculator's success.

New information that affects a speculator's perception of price movement comes from numerous sources such as statements of
future governmental policy, U.S. Department of Agriculture reports, Federal Reserve Board actions, and economic indicators. All these factors enter into a speculator's assessment of future price movement. Opinions therefore create the impetus for speculation.

In recent years, there have been articles in popular magazines focusing on the dynamics of futures markets. An article by Donald Katz (1981) for *Esquire* centered on the power, force, and drive of futures markets. Picture the opening of the treasury bill pit on the International Monetary Market. At 8:00 A.M., a gong reverberates through the air sounding the opening of the day's trading for treasury bills. Traders lurch into action. What the futures industry pegs as the "last breath of capitalism" is set into motion or,

as all the commodities boys like to say, "the last frontier"--... [begins] to undulate with spinning numerals like an electric flight departure board gone beserk. Men with public-address systems for voices... [bellow] promises for the future at one another, craning their necks unnaturally as they... [try] to watch the boards flash new numbers. All of them... [lean] into the press of the pit with their heads tilted toward the ceiling, like tired swimmers, like dogs baying at the moon (Katz, 1981:34).

To say that trading on the floor is intense is an understatement. The pace is fast and if one's trading is off a day--a hoarse voice from a cold--one pays for it dearly.

One of the substances of this intensity is leverage. As mentioned earlier, a margin of 5 to 15 percent of the face value of a contract is required as performance assurance. The value of most contracts is at least $50,000 and treasury bills are in contracts of
$1,000,000 each. Because of leverage, traders are dealing with volumes of money hundreds of times greater than they possess.

If a speculator purchases one Standard and Poor's futures contract represented by contracts of $50,000 each, the margin requirement is $6,500. The minimum fluctuation per contract is .05 points. Each .05 point change is one tick representing $25. The daily price limit move is 3.00 points or $1,500. A price move from 97.60 to 98.60 would be 1.00 or $500. The speculator could realize a gain of $500 on his long position. Traders figure their profit or loss on each contract by taking each .05 point change times $25 (Standard and Poor's 500 Stock Index Futures, 1980).

Another factor contributing to the throbbing energy in the pits is that 80 percent of speculative trades in futures lose. This all adds up to an incredible amount of risk. Every trader has a story about a fellow trader failing in the market.

Donald Katz of Esquire mazine spent time in the pits interviewing traders. In the course of his conversations with traders, one had this to say about a losing position: "Yeah, just the other day," a bearded trader said to Mr. Katz, "this guy's blubberin' and cryin' and gettin' down in front of me on his knees beggin' me for twenty grand. It was really pitiful" (Katz, 1981:34). The rewards are handsome if you win, but a loss can be devastating!

The pit is a way of life for traders: once they are a part of the economic warfare, they find it hard to drag themselves away. Walter J. Bressert, president of Hal Commodity Cycles Inc. and a
well-known futures trader in Chicago, summed the sentiment of the boys in the pit: "I wouldn't want to live without trading. The markets mean that much to me" (Hamilton, 1979:40).

In the same interview session moderated by Milo Hamilton, trader R. E. McMaster Jr. said the market helped him realize the sensation of being a free man. In the pit, one conforms to no standards but one's own. It's trader against trader--the worst a trader can do is allow his perception of reality to be affected by vested interests (Bernstein, 1979d:44).

Unchanging attitudinal sets about the market can lock a trader into a losing position and, if he fights the market, he will fail. Once mistaken perceptions of market movement color trading habits, traders will ride losses perpetually and increase their losing position. Stubbornness in perceptions about market direction seldom leads to successful trading.

So what is the key to success in futures trading? According to Walter Bressert, the best trades seem to arise out of knowing the technical aspect of what a market looks like and a gut feeling about what the market feels like (Hamilton, 1979). Three aspects of trading can be identified: (1) analysis, (2) money management, and (3) the trading factor. Analysis involves deciding when the market is going to top and bottom out and the price level at which it will do so.

Money management is referred to as the single most important aspect of trading. A trader should employ strict money management
concepts. If he doesn't manage his capital effectively, he tends to lose money faster than he makes it. This is known as a pyramiding effect. In a pyramid, a trader overcommits resources. He may become overconfident and lose sight of money management considerations. He becomes careless in watching the market and makes mistakes that may not be frequent, but they are severe.

The trading factor is the most difficult to master. It means being able to plunge head-on into a market, getting hurt, taking risks, and generally attaining a feel for it. The trading factor teaches a trader to know himself, especially after taking a heavy loss. In order to survive in the market, a trader has to keep changing. He has to learn about himself and he should not resist growth. Losses teach him how to trade. Walter Bressert said, "Take all the self-awareness courses, and throw them out the window. You don't need those with the market. The market just pounds self-awareness into you" (Hamilton, 1979:40).

What Influences a Speculator?

What influences a speculator? Jacob Bernstein, a psychologist and commodity trader, targeted some emotional factors that influence the way a person trades. Alas, these emotional factors are not discussed in commodity trading manuals. Recognition of emotional factors would allow a trader to adjust his trading system and consider the emotional responses that stand in the way of successful trading (Bernstein, 1979a).
Mr. Bernstein, in a series of commodity articles introduced the psychology of a commodity trader. He stated that fear and greed are dominant psychological factors that influence commodity trading. He reiterated that fear and greed are broad surface forces that have substantial implications beneath the individual psyche. Fear is an indication of ignorance. If one does not understand the trading system, one may experience a great deal of fear.

Too often, traders depend on advisory advice, a broker's advice, rumors, or a friend's advice rather than on firmly rooted knowledge of the trading system. This specifically applies to a small trader. He often moves too soon when a position is against him, only to watch it shift favorably after he has offset his position. This is known as being whipsawed. On the other side of the coin, he can place stop-loss orders and liquidate them before the stop-loss is hit.

Anxiety is part of the fear aspect of the trader's psyche. A trader may liquidate a position with profit potential because of anxiety stemming from sources outside the commodity markets. Fear can lead a trader to avoid making trades, initiate trades not intended from the beginning, exit good trades too soon, or retain bad trades too long.

The greed component of a trader is not insignificant. It can result in destructive pitfalls from poor trading decisions. Greed can induce a trader into holding profitable trades too long, trading in markets that should be evaded, sustaining too large a position, and overtrading a market. Greed may result in over-confidence. Bernstein noted that greed may have its beginning in
insecurity. A trader may feel insecure about a situation and overreact to compensate for the insecure feelings(s). Mr. Bernstein commented that an aggregate of fear and greed is beneficial in trading the markets. A successful trader will find the mean between the two factors and trade from there (Bernstein, 1979a).

One learns to be a winner in commodity markets by recognizing the internal perceptions and the psychology involved in futures trading. Edwin LeFever, in Reminiscences of a Stock Operator, had some words of wisdom for commodity speculators.

It is no trick at all to be right on the market. You always find lots of early bulls in bull markets and early bears in bear markets. I've known many men who were right at exactly the right time. And their experience invariably matched mine--that is, they made no real money out of it. Those who can BE RIGHT and SIT TIGHT are uncommon (Bernstein, 1979b:32).

Who is the speculating public? It is estimated that 97 percent of all commodity traders are men. Of the 5,000 traders registered on the New York and Chicago futures exchanges, 60 are women (Mackay-Smith, 1982). Traders in the pits are formerly from a variety of occupations: doctors, lawyers, professors, law officers, professional athletes, and an economist or two.

It is possible to speculate in futures contracts without being a member of an exchange by working through a futures commission merchant. Futures commission merchants are members of exchanges and trade for their own and their customers' accounts. Futures commission merchants require potential customers to possess enough venture capital to cover their future's market position and maintain the necessary margin. Once a futures commission merchant has confirmed the existence
of enough venture capital to commence trading, a customer will be allowed to open an account. It thus is possible for small speculators to speculate in futures.

Another portion of the speculative pie comes from pooled asset accounts which facilitate small investors buying into the funds. The initial investment usually required to join a fund is $5,000-$50,000. Since 1975, there are more than one dozen funds in operation with assets of $50 million.

The portion of the public that enters into futures speculation must have knowledge of the futures trading elements. There are four general market principals concerning management of capital. One should (1) become conservative as profits increase, (2) keep to a trading plan, (3) take a vacation when the account swells from winnings, and (4) diversify risk by trading in multiple contracts (Hamilton, 1979).

Before a small speculator enters into futures trading, many details must be considered and worked out. A most important first step is to choose a futures commission merchant wisely before one commences to trade. A second step is charting one's equity. A formerly mentioned trader, R. E. McMaster Jr., regularly charts his equity versus time on a graph. He looks for psychological evidence of pride as his equity increases. By charting his equity, McMaster believes he keeps a handle on his pride and greed and, thus, he stays in touch with himself (Hamilton, 1979).

**Economic Benefits of Speculation**

Before discussing economic benefits that accrue to an economy through speculation, a fallacious assumption must be clarified. This
assumption concerns the distinction between the two primary participants of futures markets: hedgers and speculators. Although hedging and speculating often are designated as two distinct activities, this is not the case. Hedging and speculation are differences in degrees of kind. Speculation involves predictions of direction in price fluctuations in futures market contracts. Hedging involves speculating on the basis. The basis (difference between spot price in the cash market and nearby futures price) is less volatile than the spot price in price movement. The cash and futures prices tend to move in the same direction. Thus a hedger's exposure to spot price risk can be reduced by transactions in futures markets because basis risk is less than spot price risk.

Hedgers who are long cash, short futures, or vice versa speculate on the price relationship between cash and futures prices.

The process of hedging divides the process of speculation into two parts: price level and price relationship. . . . Because hedging is extensively practiced by people who market commodities for which there are futures markets, futures become the central focus and pricing point of the system. Futures prices represent the general level of the price, and the multitude of cash prices that exist at any given time are established in relation to the futures (Hieronymus, 1971:150).

Hedgers are in the business of making profits. It is generally agreed upon by futures industry professionals that hedgers take out more than they put in.

A speculator contemplates the future and reaches conclusions about future price expectations. If a speculator expects prices to increase, a long (buying) position is taken; if a price decrease is perceived, a short (selling) position is initiated in futures contracts. Speculation involves forecasting price changes. Thomas
Hieronymus summed the relationship between hedgers and speculators as follows:

The speculators are long the amount the hedgers are short and short the amount the hedgers are long. Hedgers, being long cash and short futures or vice versa do nothing more than act as custodians. As far as prices are concerned, they are null—enuchs, fit only to guard the harem. They act in their storage operations in response to basis behavior but fundamentally their actions are determined by the speculators whose actions influence the basis that influences hedging (Hieronymus, 1971:142).

The economic benefits of speculation have been studied by respected futures markets experts such as Holbrook Working, Roger Gray, David Rutledge, Mark Powers, Thomas Hieronymus, and Hendrick Houthakker. These experts have agreed on three major economic advantages of speculation: (1) risk-shifting opportunity for hedgers is feasible because of speculation, (2) speculation enhances market liquidity, and (3) price volatility is dampened by speculative actions.

By accepting the spot price that risk hedgers are seeking to minimize, speculators fulfill one of two economic functions mandated by the Commodity Exchange Act. The passage states that futures transactions are, or reasonably can be expected to be utilized by producers, merchants, or consumers, engaged in handling such commodity (including the products, by-products, or source thereof), in interstate (including foreign) commerce as a means of hedging themselves against possible loss through fluctuations in price (Standard and Poor's 500 Stock Index Futures, 1980:27).

Hedging is possible because documentation has shown that speculators are on the other side of most hedging contracts. Hedgers minimize the price risk of ownership by shifting the risk to those willing and able to bear the risk. Speculators are not altruistic in their endeavors but assume risk for potential profit. To the extent that a
commercial hedger cannot eliminate risk from fluctuating spot prices, it will be affixed to the product cost. The cost ultimately will be borne by consumers; therefore, a circle is created by the futures process. Hedging techniques reduce marketing costs. Speculation facilitates hedging which enables the spot market for commodities to function more efficiently. The consumers of storable or nonstorable commodities eventually are the winners.

Speculators provide liquidity to futures markets. Market liquidity has two aspects: marketability and certainty of price. Marketability refers to the ease associated with an asset's disposal. The easier it is to transfer ownership of a futures contract, the more attractive it is to potential market participants. Thus marketability contributes to the liquidity of a futures contract market.

Certainty of price entails the greater the degree of certainty of an asset's value, the more liquid the market. Speculators affect liquidity by improving the accuracy for which forward prices forecast futures prices. This reduces uncertainty of an asset's value by augmenting the solidity of forward prices.

The business of speculators—indeed, their comparative advantage—lies in forecasting price developments. . . . The effects of speculation improve the informational context of forward prices and enhance the confidence attached to forward prices as estimates of future spot price (Burns, 1979:45).

The more speculation present in a contract traded on an exchange, the greater the liquidity of the contract. This, in turn, improves the ease of entry and exit in contracts. Proposals to curb speculation would create an imbalance in the liquidity of contracts and aid the creation of disorderly markets.
Speculation suppresses price volatility. Since the 1940s, speculation has been suspected by legislators as spurring price fluctuations. This premise is incorrect. Hedging activity in futures contracts creates buying and selling pressures. Without speculative activity to counterbalance hedging, prices would be more susceptible to wide fluctuations. The trend toward more price volatility in speculative scarce markets is supported by data collected by the Commodity Futures Trading Commission (CFTC). In periods of inactive speculation, prices are more erratic.

The CFTC requires all traders who have a large share of open interest in futures contracts to report their positions and identify themselves as speculators or hedgers. The data collected by the CFTC are useful to determine the performance of futures markets based on the conduct of traders. Empirical evidence of how futures trading affects cash prices is limited, but studies done on the variability of potato, wheat, and onion cash prices report a reduction in price volatility with the existence of futures contracts for these commodities (Tomek, 1981).

Futures and cash prices tend to be simultaneously determined. This observation, combined with studies by David Rutledge of 136 futures contracts exploring the relationship between volume of speculation and futures prices, supported the premise that speculation does not induce variable cash prices. A causal relation between price volatility and speculation was not found in 134 of the contracts studied. Rutledge interpreted these findings as evidence that speculation does not contribute to price variability, it is a reaction to price variability (Tomek, 1981).
"Speculation also may influence resource allocation indirectly by assisting hedgers in the mobilization of capital" (Tomek, 1981:15). A farmer who has a hedged position in the futures market may be able to borrow more capital against the hedged position than against an unhedged position. Seminars are held throughout the country, sponsored by the exchanges, to educate agricultural bankers in the usefulness of hedging (Besant, 1981).

Futures markets allow hedgers to make decisions about their inventories from year to year. Hedgers can improve the allocation of their inventories over time with the assistance of futures markets. Improved allocation of resources through futures reduces annual price variation. Speculators afford hedgers an opportunity to move stocks in and out of inventory by providing liquidity to futures contracts. Speculators assess the inventory requirements of hedgers and base their trading decisions on these assessments (Tomek, 1981).

In endeavoring to explore the price effects of futures speculation, two issues must be considered: (1) the level of hedging in the futures contract and (2) accommodation of the hedging position by speculators (Peck, 1977). If hedgers can adjust the supply and demand of their products through futures transactions, speculation is adequate. Speculators accommodate hedgers by anticipating inventory requirements and reflecting this appraisal in futures transactions. Hedgers are willing to pay successful speculators a rate of return for this service.


Chapter 3

GOVERNMENTAL REGULATION OF FUTURES MARKETS

Early Legislation

The first congressional bill to regulate futures markets was introduced in 1884. By 1921, more than 200 bills involving regulation of futures markets or prohibiting them had been introduced. During these years, futures trading was subject to public criticism and governmental concern over the impacts on commercial producers and consumers. In response to public concern, the Future Trading Act was passed by Congress in 1921. The Supreme Court ruled the act unconstitutional in May 1922 because, in the court's opinion, the act was an illegal use of Congress' taxing power.

The passage of the Grain Futures Act of 1922 came on the heels of the Supreme Court's ruling of unconstitutionality of the first attempt by Congress to legislate market regulation. The Grain futures Act has its base in the commerce clause of the Constitution. In this act, Congress set up a commission headed by the Secretary of Agriculture, the Secretary of Commerce, and the Attorney General. The commission's powers were to require contract markets to keep records of transactions, compile daily reports on volume of trading and open interest, and compile reports on large position traders. From this pool of facts, the commission based its regulatory activities.
Section 3, the most important in the act, has had the greatest impact on congressional opinions of futures markets since 1922. It is considered the keystone of market regulation. At the time section 3 was written, Representative Ellis believed it served one purpose only—to convince Chief Justice Taft and the other justices that the bill was constitutional.

The evidence before the House, on this particular bill anyway, consisted, basically, of the solicitor of the USDA saying that the legislation was written to be constitutional, and that [it] had included those "facts" in section 3 for that reason and that reason alone. A Mr. Wells of Minneapolis—a vice-president of Peavey & Company—had pointed out to the Committee, however: "I fail to find in the record any testimony from men of experience that transactions are extremely susceptible to speculation, manipulation, and control" (Stassen, 1981:40).

Section 3 is the foundation on which the futures industry is regulated. It tells us that

transactions in commodities . . . known as 'futures' are affected with a national public interest. "They are carried on in large volume." The "prices involved are generally quoted and disseminated," etc. Section 3 goes on to declare, however, that "the transactions and prices of commodities on . . . boards of trade are susceptible to speculation, manipulation, and control, and sudden or unreasonable fluctuations in the prices thereof frequently occur as a result of such speculation, manipulation, or control, which are detrimental to the producer or the consumer and the persons handling commodities . . . and such fluctuations in prices are an obstruction to and a burden upon interstate commerce . . . and render regulation imperative for the protection of such commerce and the national public interest therein (Stassen, 1981:34).

With a legacy such as this, is it any wonder that speculation is viewed as a harmful activity by the average reader of section 3? By establishing this section in the guise of interstate commerce which Congress oversees, speculation in one fell swoop was condemned as a transaction, on the boards of trade, which impeded the flow of
interstate commerce. The act has been renamed since 1922, but section 3 has not been changed.

Hearings began on the Grain Futures Act on June 22, 1922. Mr. Rainey, a Representative from Illinois who opposed the bill, complained that the bill was reported out of the Agricultural Committee in the House without being fully considered by the committee. The bill was not read before the Committee of the Whole of the House and the bill passed without receiving a quorum. Thus a law was made in the 1920s—a law that still governs a $2 trillion industry in the 1980s.

The Commodity Exchange Act

The Grain Futures Act was renamed the Commodity Exchange Act (CEA) in 1936.

The fundamental purpose of the Commodity Exchange Act is to insure fair practice and honest dealing on the commodity exchanges and to provide a measure of control over those forms of speculative activity which too often demoralize the markets to the injury of producers and consumers and the exchanges themselves. (Campbell, 1957-1958:223).

It seems paradoxical that the purpose of the CEA is to promote honest dealing on the exchanges but that the foundation of regulation was legislated in a less-than-honest manner. Nevertheless, the CEA's purpose is to promote orderly trading on the futures exchanges and protect commercial hedgers and consumers from speculators.

The Commodity Exchange Authority was set up as an agency under the U.S. Department of Agriculture to administer the act. The act was intended to strengthen the law regarding futures markets. Thus the
The act of June 15, 1936 was renamed the Commodity Exchange Act, but it retained section 3 as part of the statutes.

The Commodity Exchange Authority was given the power to set trading limits. Different trading limits were applied to different commodities. These trading limits do not apply to bona fide hedging transactions. The act gave the Secretary of Agriculture the authority to designate boards of trade as contract markets if they met certain conditions and requirements. The duties of contract markets include establishing bylaws, record keeping, allowing for inspection of books and records at all times by the U.S. Department of Agriculture's representatives or the U.S. Department of Justice, and setting delivery requirements. Contract markets have a duty to ensure that daily business remains orderly. The act requires future commission merchants and floor brokers to register with the Secretary of Agriculture.

The CEA also prohibited manipulation of the markets, but it has not defined manipulation. "Consequently, uncertainly and imprecision have resulted as courts and administrative agencies have sought to distinguish between legitimate trading activity and manipulation" (Harrington, 1981:252). This failure to pinpoint an objective standard to measure possible findings of manipulation has caused problems. Usually the tendency for outsiders of the futures industry has been to associate only speculation with manipulation. Congress intentionally left out a definition of manipulation--it is for the courts to decide.
The Commodity Futures Trading Commission Act

On October 23, 1974, President Ford signed into law P.L. 93-463 entitled "Commodity Futures Trading Commission Act of 1974" (CFTC Act). The CFTC Act is a major overhaul of the CEA. From 1964-1974, trading volume on the twelve organized exchanges increased 400 percent (there now are eleven organized exchanges). The CEA, an agricultural bill, had become archaic. The definition of commodities under the old act had become outdated. None of the new contracts in foreign currency or the proposed GNMA futures contract sponsored by the Chicago Board of Trade were covered under the old act.

The futures industry wanted to expand into nonfood futures trading. Congress was under public pressure to investigate whether futures trading was responsible for the rising cost of food. Congress viewed the futures markets in their traditional agricultural role, thus it centered on food prices and marketing. The futures industry realized that its agricultural role was diminishing and evolving into contracts in nonfood areas such as the aforementioned foreign currency contract and others such as silver, lumber, and numerous contract proposals.

Because a regulatory gap existed in those futures not named in the CEA futures industry, officials felt that scandals would arise because "antifraud provisions of the Act, and the important requirement that all customer funds must be segregated from the brokers' own funds, were inapplicable" (Johnson, 1976:4). Congress and the futures industry were anxious to see the CEA revamped.
The CFTC Act has a direct impact on speculators:

Section 4a of the Commodity Exchange Act authorizes the Commission to establish limits on the number of contracts a speculative trader may hold, directly or indirectly, individually or with others through an express or implied agreement or understanding. Persons engaged in "bona fide hedging transactions" are not subject to this prohibition (Schief and Markham, 1978-1979:50).

The speculative trading limits were established in 1936; however, the CFTC Act contains new enforcement provisions. Speculators found in violation of section 4a are subject to a $100,000 fine for each violation or a 6- to 10-year jail sentence. If speculators trade in concert, they will be treated as one position for purposes of the trading report limit. The CFTC may also publish findings of an investigation (some restrictions do apply to the publications). The commission has, in the past, published the position of speculators who violated speculative limits.

There are two major changes in the agency that regulate futures: (1) the Commodity Futures Trading Commission is set up as an independent regulatory agency with exclusive jurisdiction over contracts dealing in futures and (2) the CFTC is part of the sunset regulatory agencies. In other words, the CFTC was given the authority over futures markets for four years beginning in 1974 and ending in 1978. In 1978, hearings were held on CFTC to judge whether it should continue to exist as a regulatory body. The CFTC was reauthorized by Congress until 1982 and will be subject to future reauthorization in that year. Every four years, the CFTC must prove that its policies and responsibilities are congruent with the congressional mandate.
The role of the CFTC is summarized by Dr. Mark Powers.

The new Act strengthens the exchanges' role as quasi-public institutions and brings almost all of their activities under regulation of the federal government. Every contract market (exchange) has to be specifically approved by the Commission. Everybody involved in execution of futures contracts and in dealing with the public has to be registered with the Commission and has to pass examinations and fitness requirements established by the Commission. The new Act extends materially the concept of the public interest to be protected by including not only former interests, but the interests of all people—producers, processors, merchants, other market users and consumers (Powers, 1977:245).

Contract approval by the CFTC will be granted only if the contracts proposed are in the public interest and if they can be justified economically.

The structure of the CFTC is unlike previous regulatory structure of futures markets. The CFTC is composed of five commissioners. One serves as a chairman. The CFTC has three operating divisions and numerous staff offices. The President appoints the commissioners with the advice and consent of the Senate. The terms are staggered and exist in five-year increments.

The CFTC has two goals: (1) to protect the users of the futures markets from abuses and (2) to maintain the economic utility of futures markets. The CFTC spent the years 1974-1978 solving the problems inherent in the start-up of an agency. Since 1978, the CFTC has directed more of its attention to enforcement.

The actions of the CFTC currently have been more controversial than before 1978. Problems in the CFTC surfaced in the reauthorization hearings and drew criticism from persons in Congress and witnesses of the hearings. In the CFTC, Congress has created a regulator of futures markets with more power and authority than ever before.
Congress built these new laws based on past laws, but the old laws have a shaky foundation.

As mentioned earlier, the CFTC was up for reauthorization in 1978 before Congress. Hearings were held by committees in the House and Senate that had jurisdiction over the CFTC.

The basic complaint against the CFTC by persons in the futures industry was that the commission attempted to impose too many regulatory initiatives too soon and with little understanding, particularly at the staff level, of the subtleties of the futures market (Young, 1978:876).

The problems experienced by the CFTC were from internal and external sources. Internally, the CFTC suffered from a high turnover of key personnel, inadequate funding, and poor administration. Externally, the CFTC was challenged by the Securities Exchange Commission's bid to seek jurisdiction over financial futures. The U.S. Treasury also wanted to have some impact on the trading of government securities futures.

Robert Wilmouth, president of the Chicago Board of Trade, and Walter Brinkman, president of the Board of Trade Clearing Corporation, testified in favor of revoking the CFTC's independent status and placing it back under the U.S. Department of Agriculture. Other futures industry officials believed the CFTC's independent status should remain intact and supported its exclusive jurisdiction over futures markets to be extended for another four years.

At the conclusion of the hearings, the CFTC was extended for four more years; it is being reviewed again now. The reauthorization of the CFTC hearings will be along the same format as those in 1978, with a difference: the new hearings will present more controversy
between opposing factions of the CFTC's perceived role as the sole regulator of futures transactions than in 1978.

Some important changes were made in the CFTC during the 1978 reauthorization process.

1. Permit the CFTC Chairman to serve at the President's pleasure.
2. Suspend commodity options trading pending CFTC documentation of its ability to regulate such transaction.
3. Provide additional subpoena power to the CFTC.
4. Authorize states to bring action seeking injunctive relief for violations of the Commodity Exchange Act or CFTC rules and regulations.
5. Revise penalties for fraudulent industry practices and CFTC regulatory violations.

Particularly important are changes 4 and 6. These two areas came to the front in 1982 and questions of jurisdiction were raised. As of this date, they are not being settled.

Since the reauthorization, the actions of the CFTC from 1979-1982 have been highly publicized. Dubious publicity was garnered in March 1980 over the silver futures market near collapse. At that time, journal and dailies such as The Economist, Forbes, Business Week, Dun's Review, Barron's, and the Wall Street Journal reported the circumstances leading to the near collapse and offered respective opinions as to how this crisis arose. Blame was placed upon the CFTC, the Chicago Board of Trade, the Chicago Mercantile Exchange, and the speculators trading on these exchanges.

The phenomenal growth in the financial futures and the Kansas City Board of Trade's stock index future contract in 1982 have brought new considerations in the CFTC's role in this changing environment.
The hearings should be interesting as to interpretation of the role of the speculator in equity-based futures contracts by the futures industry, Congress, the CFTC, and other regulatory agencies.

The commodity legislation handed down from Congress since 1922 can be likened to a letter with postscripts. Beginning with the first act, Congress has passed amendments, banned trading on onion futures in the late 1950s, experienced a major overhaul of the CEA, and reached a point where futures regulation will be reviewed every four years. Congress continues to add postscripts to the foundation of legislation without tinkering with the keystone laid in 1922.
General Misunderstanding

The acquiring of knowledge of futures markets would be piece­meal if left solely to newspapers and periodicals to provide people with a basic understanding of futures markets. To be in a situation to understand futures markets requires reading and researching of the topic. In lieu of pursuing the subject matter on its own, the general public allows others to do it—elected officials. The average citizen may not know how to put a spread on between CDs and treasury bonds, but he knows how to pull a voting lever. Elected officials have responsibilities toward the general public as described in the Constitution. Their main obligation is to protect the national public interest. Futures markets are in keeping with national public interest, therefore Congress regulated futures markets as a matter of public policy.

What if the average congressman does not understand the futures markets any better than his constituents? Congress has committees. The House and the Senate members assign their numbers to committees of various subject matter to allow members to concentrate on selected issues. What transpires if committee members do not fully understand the issues being studied by their committee? A cleft occurs in the process. Bargaining and compromising ensue at the committee level. It is possible for a minority faction on the committee to bring bills...
through the committee onto the Senate or House floors. Therefore some members on the committee may not possess a complete understanding of the specifics of a particular bill.

It is postulated that this is how the futures legislation was made into law. A small aggregate of congressmen were responsible for guiding the premier futures legislation through Congress without the total body understanding the supposition of futures markets. This handful of congressional members had an antispeculation prejudice which stemmed from their misunderstanding of futures markets. An antispeculation bias was consequently embedded in the foundation of the first futures statutes. This predicament has been extended in succeeding amendments.

The results of misunderstanding by the legislators continues to the present day. Robert K. Wilmouth, president of the Chicago Board of Trade, said,

There is, and I emphasize this, a total lack of understanding of the futures markets in Washington, D.C., almost from the top level right on down to the lowest clerk in Washington. We were confronted recently with a number of queries from various congressmen and their staffs, essentially saying they felt there ought not to be any short sales, any short speculation on the CBT [Chicago Board of Trade], unless we could prove their validity. We were fortunate enough to call Roger Gray and David Rutledge from Stanford to put together very hurriedly, within a matter of about 48 or 72 hours a paper on short speculation and the values of it (Wilmouth, 1981:2).

If the legislators and their staffs understood futures markets and their relation to other markets, this never would have been proposed.

It is true that in any situation where a person lacks background in the subject matter of an issue, any insight provided by an
expert opinion or journal article will contribute to the person's edification. People accumulate knowledge to further their understanding of a discipline and its relatedness to the whole community. Futures markets are a part of that community and speculation is an aspect of futures trading. Some persons may have a surface understanding of speculation, but that is not sufficient to lend true insight into the activity. Insight into speculative activity is necessary in order to see its value to the whole arena of futures trading. Insight can be gained by perceiving the role of the speculator and placing it in perspective.

The limited understanding of speculation was recently demonstrated in a congressional hearing. The scene was the Senate Committee on Agriculture, Nutrition, and Forestry. The witness was James Stone, the proposed nominee to chair the CFTC in 1979. The line of questioning probed Mr. Stone's grasp of futures markets. The congressman questioning Mr. Stone in the following passage was Senator Leahy. Senator Leahy mentioned to Mr. Stone that he had read extensively about futures markets and had visited many of the eleven exchanges.

Senator Leahy. I realized as I think my colleagues did, that while we don't claim any greater or lesser intelligence than the average person we represent here, we had only begun to scratch the surface of a very complex market. There are people that have been in the business for 20 years and they told me that they are just beginning to learn it, and many of these people are very successful. Have you ever visited the floor of any exchange?

Mr. Stone. I have never been on the floor of an exchange. I have been in the gallery of the Chicago Board of Trade.

Senator Leahy. Have you ever talked with the people that trade on the floor? Have you a sense of the competition there?
Mr. Stone. I have not, Senator. (U.S., Congress, Senate, Hearing, April 4, 1979:26).

Senator Leahy acknowledged the complexity of the futures markets and recognized the importance of understanding the industry participants. Yet Mr. Stone had never conversed with a floor trader as part of his preparation for a possible appointment to the CFTC. Although the Senate committee later ratified Mr. Stone's nomination, it appears that a problem was exhibited in the passage. The problem was not new. Was it presumptuous to have expected Mr. Stone to speak with floor traders of the industry that he was to regulate? This is doubtful. Certainly Mr. Stone could have gained some insight into the speculators' perception of their role and how that perception affected futures trading.

The Gambling Myth

The texts of commodity legislation since 1921 are replete with examples of Congress linking speculation in futures markets with gambling. This legacy has aided in perpetuating the notion that speculators are an unscrupulous lot. The speculation-gambling link was most popular in the 1920s and 1930s when Congress was developing statutes on commodity regulation. Since then, the association has moderated somewhat as Congress focuses on other damaging activity in which speculators engage—manipulation of prices. Nevertheless, the gambling bias has remained and it is evident in today's congressional committee hearings.

The next passage can be credited to Senator Capper's oration before the Senate in 1921. A review of this and other passages
recorded in the *U.S. Congressional Record* and committee hearings since the first regulatory act until the present is proof of the gambling bias.

The Future Trading Act of 1921 had a willing sponsor in Senator Capper of Kansas. The speech he made in reference to the bill was delivered when the populism movement was alive and harborers of populism resided in Washington, D.C. Senator Capper was known for his dazzling public speaking.

Mr. President, it is nothing new that we hear today from the producers of food, from grain dealers and millers, and from victims of speculation carried on without restriction, of the abomination of speculations in these basic products. . . . During the past year the price of wheat and corn has been determined to a large extent not by the demand and supply of the commodity itself but by the fabulous quantities sold on the exchange that never had any existence, that no grain farmer in the world ever planted, ever toiled over its cultivation and harvest, or offered for sale. . . . Mr. President, it is against the law to run a gambling house anywhere within the United States. But today under the cloak of business respectability, we are permitting the biggest gambling hall in the world to be operated on the Chicago Board of Trade. The grain gamblers have made the exchange building in Chicago the world's greatest gambling house. Monte Carlo or the Casino at Habana are not to be compared with it. . . . Mr. President, every member of a grain exchange who testified before the Agricultural Committee of the Senate acknowledged that there is at times excessive speculation and undesirable speculation in the futures market. It was brought out that a few big traders at times influence prices—manipulate the market—by the great volume of their operations. Also it was shown that a continually fluctuating, and not a stable, market is the desire of the speculators. . . . The plain truth, Mr. President, is that through manipulation of the market the big speculators on the Chicago Board of Trade are undoubtedly a powerful factor in fixing the price of the farmer's wheat. . . . I fear this country will not long continue to produce the finest wheat in the world if we continue to let the wheat gambler fix the price (*U.S., Congressional Record*, Vol. 16, 4761, 4763, 4768, August 9, 1921).

Senator Capper's legislation was declared unconstitutional in May 1922. Congress, however, was not to be denied. Forty days hence, a
new bill was drawn up with its statutes based in findings of fact. The staff of the House Agricultural Committee researched the issues and blithely ignored views of expert testimony presented in congressional hearings. From where were the findings of fact drawn? If a staff member of the Agricultural Committee had read a congressional report prepared in 1890, a legislative definition would have added knowledge to his facts in relation to

"options," defined as future contract in which delivery is not required, and "futures" defined as the sale of a commodity not owned by the seller at the time of the sale, that obviously those who deal in "options" and "futures" contracts, which is mere gambling, no matter by what less offensive name such transactions may be designated, neither add to the purpose by their calling, but on the contrary. They speculate in fictitious products (Campbell, 1957-1958:219).

Apparently these solemn declarations of economic facts by Congress were good enough for the Supreme Court. The Grain Futures Act became law in 1922.

The mistake of linking the role of a speculator with that of a gambler continued into the 1930s. Prior to the 1936 passage of the CEA, the usual process of congressional hearings on the issue were held. The line of questioning that follows occurred in the Committee of Agriculture and Forestry in the Senate, 1st session, April 1936.

The discussion was between Senator Norris and a witness, Mr. Vesecky:

Senator Norris. You would call that gambling?

Mr. Vesecky. You might call it gambling or speculation.

Senator Norris. I am not one who objects to speculation in a modified way. I think that it is probably legitimate. I think, as a matter of fact, that when a man buys wheat for future delivery in a sense he is a speculator because he doesn't know what the price is going to be when the time comes, but if he buys without reference to the handling of the
commodity itself, just goes in and buys and sells without reference to anything, is he a hedger or a gambler?

Mr. Vesecky. He is not a hedger at all. He is either politely called a speculator or otherwise might be called a gambler, whichever one you want to call him.

Senator Norris. If that were prohibited by law, prevented in any way, [is it] your idea that it will have a beneficial effect upon the market generally?

Mr. Vesecky. I think if excessive speculation, excessive long lines or short lines—either one—and excessive sales and purchases on any one day are limited or prohibited, that it will have a beneficial effect on the market. It was proven several times during the last big flurry in July 1933, that it was the creation of these long lines at one time that made the bad break (Hieronymus, 1971:139).

In this exchange, one realizes the confusion over the role of the speculator. A hedger is legitimized by his underlying position in the cash market for the commodity and his speculation on the basis is acceptable because of this reference to the tangible commodity. Senator Norris did not understand buying and selling in futures contracts without a reference to the cash market. He has a difficult time understanding how one could sell something he did not own or buy something he did not want. This idea, one of the basic elements of futures trading, can be traced to the first set of trading rules established by the Chicago Board of Trade in 1865. Senator Norris was confused by this notion and wondered if trading of this nature should be prohibited.

Mr. Vesecky answered that the imposition of the speculative position and trading limits would be beneficial to the markets. This line of reasoning is detrimental to the economic usefulness of futures markets. Congress, at the time of this hearing, understood the futures markets' existence as a risk-transferring mechanism for
commercial users who are subject to risks from economic and external factors. Congress' attitude toward speculation, since speculators have no physical commodity to deliver into the cash market, is that speculators are responsible for fluctuation in disruptive prices that impede the orderly flow of the markets. Thomas Hieronymus (1971), a widely respected economist and authority on futures markets, said this attitude fails to recognize speculation in price formation which, in turn, means Congress does not understand the role of pricing in the economic system. For example, in the Joint Committee of the Economic Report in December 1947, Representative Rich asked the administrator of the Commodity Exchange Authority how Congress "could stop speculation and let the legitimate trading persist (Hieronymus, 1971:138).

The speculator in the marketplace fulfills vital economic functions that facilitate trading in basic commodities and financial and interest rate futures. Hedgers are shifting risk to speculators who are willing to bear risk for a chance of gain. Research has been done in markets that are thinly traded and have few speculators. Roger Gray (Peck, 1977)\(^2\) found that a lack of speculation increased price volatility. Speculators who are day traders and scalpers dampen price swings because they are trading against the markets. The speculators assess price movement and risk venture capital to establish an open interest in the direction they feel prices are moving.

The past couple of decades have focused antispeculation bias on price fluctuation and manipulation of the markets by speculators.

\(^2\)Ibid.
Some congressmen have had a better understanding of futures markets than others. When Congress held hearings in 1973 for bills submitted which would overhaul the Commodity Exchange Act of 1936, Representative Poage, chairman of the House Committee on Agriculture in 1973, defended speculation. His remarks were made during the discussion of drafting a new bill that would become the CFTC Act of 1974.

Representative Poage conceded that few members of Congress are fully aware of the complexities of futures trading and the role of the federal government in regulating futures markets. Poage briefly summarized the history of legislation concerning futures markets since 1922. In the following discourse, he praised speculation:

Since their inception, the necessary liquidity in contract markets has been provided by speculators, or those who have no existing cash risk to offset through the purchase or sale of futures contracts. Speculators, subject to certain limits as provided by the Commodity Exchange Commission, seek to profit off the shifts in price levels of the contracts. In so doing, they provide a real service to the market and its users, by providing liquidity (U.S., Congressional Record, Vol. 119, 41332, December 13, 1973).

Representative James Whitten, in hearings before a subcommittee of the Committee on Appropriations in 1977, had this to say:

My observation from this side of the table has almost convinced me--although I have not dealt with it personally in any degree at all--that the gamblers on the market are an essential part of market operations. Without them, there could not be any operations on a hedging basis at all. We have been told through the years that as the Government added commodities to regulation, the gamblers then took to what was left out. I think the records will kind of show that, so I would like you to place in the record, the dates when various Commodities were added (U.S., Congress, House, Hearing, March 22, 1977:94).

Does "the gamblers" sound familiar?

Representative Whitten acknowledged that speculators are necessary to the legitimate hedging role; he also stated that, as
contract markets added contracts based on financial instruments and foreign currency futures, speculators (gamblers) rushed in to trade because they were not commodities covered by federal law. One can forget the economic reasoning behind speculators entering these markets; everyone knows that speculators were really seeking to get out from beneath government regulation.

Representative Whitten's 1977 remarks were made in regard to the reauthorization of the CFTC. And still the trend continues . . . .

The Senate held hearings on the CFTC in 1978 before the Subcommittee on Agricultural Research and General Legislation of the Senate Committee on Agriculture, Nutrition, and Forestry. Mr. Leo Melamed, a former chairman of the Chicago Mercantile Exchange and presently serving as a special counsel to the exchange, was a witness. Mr. Melamed, at the request of Senator Hayakawa, explained how the futures industry is highly unique and highly complex. He explained the differences between futures markets and securities to the subcommittee. Mr. Melamed offered an explanation of the speculative trading done in futures markets:

In the field of futures, there is virtually but one nonhedge trading technique, and that is for profit—speculation for profit. Irrespective of what else you call it, in the futures market if you are not a hedger, if you are not risk shifting or attempting to preserve or prevent risk, then you are speculating and that would be your only reason for going in the futures market; so that objective is but one (U.S., Congress, Senate, Hearing, March 21, 1978:134).

Senator Hayakawa, who questioned Mr. Melamed on his explanation of this complex area, was extremely grateful. He was so grateful that, at the end of his questioning, he remarked, "We who are retired
professors of English don't know very much useful in the business world. . . . I am very grateful to you for your contribution to my education" (U.S., Congress, Senate, Hearing, March 21, 1978:137).

The 1980s may well bring the same type of misunderstanding and misinformation of the speculator's role as Congress experienced in the past. In 1980 the same Senate Committee on Agriculture, Nutrition, and Forestry held hearings in regard to the nomination of James Stone, potential member of the CFTC and its chairman. These hearings were held shortly after the silver futures market price volatility episode in March 1980.

Each senator on the committee took a turn questioning Mr. Stone. In his first question, Senator Melcher asked if a certain amount of gambling occurred at the exchange. This misunderstanding of speculation is disturbing. If the public's elected officials do not understand basic concepts of economic markets that are in the public's interest (as defined by Congress in Title 7, section 3 of the U.S. Codes), how well are these interests being protected? Not only is speculation misunderstood, but some other aspects of futures trading are not clearly understood by Congress.

Senator Melcher's other questions to Mr. Stone indicated that the senator was unable to identify basic futures trading terms.

Senator Melcher. Do you believe the Commission ought to prohibit trading by commission people on the floor for their own account?

Mr. Stone. Should the Commission prohibit dual trading? Is that the question?

Senator Melcher. No; trading for their own account by commission people on the floor.
Mr. Stone. That practice is often called dual trading and it raises an issue which needs more facts before it can be decided (U.S., Congress, Senate, Hearing, April 4, 1979:29).

If a senator on the committee, which has jurisdiction over the commission which regulates futures markets, cannot identify basic terminology, one wonders about his understanding of the purpose of such markets. Dual trading is a sensitive issue. The more liquid a market is, the more smoothly it functions and aids the ease of entry and exit of the market. Prohibiting dual trading would affect market liquidity. The consequences of such an action must be considered before an outright prohibition is imposed.

In surveying the U.S. Congressional Record and congressional hearings in regard to futures markets, the problem becomes exceedingly apparent. Hedging is considered to be a bona fide use of futures markets and speculation is considered to be a necessary evil.

The lack of understanding of the speculator's role is sharply revealed when government takes action to "hurt" and "punish" speculators. Their policy decisions reflect a lack of understanding of the role of free markets and of speculators' contributions to that role (Burns, 1979:113).

As history has shown, Congress set a precedent for the link of speculation to gambling. It defined gambling in Title 18 of the U.S. Codes:

Gambling in the federal law is defined to include among other things pool-selling, book-making, maintaining slot machines, roulette wheels or dice tables, and conducting lotteries, policy, bolita or numbers games or selling chances therein (18 U.S.C. § 1955(b)(2) (1978).

As stated in federal law, futures trading has no relation to gambling. Gambling may cover more items than those listed above, but futures are not part of them. Federal gambling statutes do not
prohibit trading in futures contracts. As far as state gambling laws are concerned, they are preempted by CFTC-designated futures contracts. The CFTC Act of 1974 gave exclusive jurisdiction to the CFTC over futures markets. Where state laws are in conflict with federal law in regard to futures markets, the state laws are superceded by the CFTC mandate of exclusive jurisdiction.

The people of the United States extoll competition in economic endeavors as a thing of beauty. Competition rewards those who produce goods people want; it punishes those who produce goods people don't want. The keystone that synthesizes competition is the pricing mechanism. Every product in a competitive market of storable and nonstorable commodities has a price. Prices fluctuate to reflect supply and demand for these goods.

One of the characteristics of pure competitive markets is the presence of many buyers and sellers, each with little influence on price. Another characteristic of pure competition is that products for the particular market are homogeneous. Futures markets meet the above requirements for pure competition.

Contracts on exchanges typically have many buyers and sellers, thereby reducing the possibility of an individual manipulating the price. Futures markets are impersonal. Trading is done publicly in the pit and all price information is made public. No secret dealings at prices away from the contract market are made. Futures trading rules for contracts require the terms to be standardized. Standardized contracts make for interchangeable lots of equal grade. The clearing corporation of each exchange assumes the open interest of each trader, thus
traders do not know with which principal they are dealing because of the clearing corporation's stance. These conditions must exist before a futures market can be viable. An established futures market fosters competitive behavior. It is the market imperfections that receive publicity.

A long-standing concern of Congress, farms, and other members of the public is that speculators manipulate prices too high or too low. Roger Gray and David Rutledge, in empirical analyses of futures markets, found little evidence that futures markets are in serious disequilibrium over periods of time (Peck, 1977). Accusations by the public blaming speculators for price fluctuations is akin to killing the messenger who brings bad news. Instead of public policy concentrating on improving market performance, it endeavors to curb speculation through speculative position limits and raising margin requirements for speculators. People cannot visualize that speculation for profit is a legitimate function of futures trading.

A timely example illustrating the problem has been the controversy surrounding the introduction of stock index futures.

There's opposition in some quarters including Congress, to the new market. The main concerns are that stock index futures will draw speculators away from stocks, thereby making markets more volatile and possibly making it more difficult to underwrite equity capital. Funny, isn't it how speculators in Kansas City futures are "bad guys" engaging in the frivolous activity, but the same speculators on the New York Stock Exchange are "good guys" who provide market liquidity? (Zweig, 1982:26).

Mr. Zweig's point is well taken. When the public and Congress look from the vantage point of the gallery over the pits, they see no white hats. Critics of the growth in financial futures contracts breathed a sigh of relief when the New York Futures Exchange opened

\[3\text{Ibid.}\]
for business in 1980—as if the association between the New York Futures Exchange and the venerable New York Stock Exchange would legitimize the success of an industry dominated by two exchanges west of New York City!

Perusing the committee hearings in the Senate pertaining to James Stone's nomination as a member and chairman of the CFTC, the reader gains insight into whom Congress is blaming for price volatility.

Senator Dole. There has been a lot of frustration by the American farmer, the American producer—in fact, it has been suggested by some that we abolish the boards of trade and probably the Commodity Futures Trading Commission, too, because they see it as controlled by speculators and controlled by those who would hold down the farmer's price. . . . I think it is fair to say there is a strong body of opinion out there in the countryside, which you may discover if you continue to visit around the country, that feels this entire system is designed for one purpose—to call it gambling may not be the correct thing, but some people lose and some people make money, and it is all at the expense of the American producer. I don't know how you address that. It is a hard thing to get a handle on but I think you are probably aware of this concern. It is not shared by everyone but there are a number of people that don't understand how it works who are quick to make that judgment. Have you had an opportunity to discuss any of these concerns with bona fide farmers? (U.S., Congress, Senate, Hearing, April 4, 1979:36).

Fortunately, Mr. Stone could answer Senator Dole's last question in the affirmative because he had spent three days in Iowa doing farm chores on a bona fide farm that raised bona fide pigs. He found it helpful in deepening his understanding of agricultural commodities.

Senator Dole proceeded to offer some of his insight into exchanges. "I have visited an exchange a few times and I still don't understand what is going on. I just kept my hands down. That is the first thing they tell you" (U.S., Congress, Senate, Hearing, April 4, 1979:36). Senator Dole's visit to the exchange floor was more than Mr.
Stone had done thus far; the reader will recall that Mr. Stone had never been on the floor of an exchange, only in the gallery.

Senator Dole voiced the fears held by some people that speculators hold down the farmer's price. Senator Dole said he did not know how to address that premise. It is obvious that Senator Dole did not know how a speculator functions in futures trading or he could have discussed the issue with those who fear speculators profit at the expense of a producer. If members of the Senate committee which oversees the CFTC cannot respond to charges that speculators manipulate prices, they do not understand futures markets.

Manipulation of a futures price is to abnormally depress or raise the price outside the normal influences of supply and demand. It is said that manipulation occurred in the March 1979 wheat contract and the silver market in 1980. In order for a trader to manipulate prices, large financial resources are required. Even then, if he manipulates a price in his favor, he encounters a problem. When the trader moves to profit from the manipulation, prices often move to their former level. The probability of successful manipulation is therefore small.

Market corners, a form of manipulation, are established when a trader has possession of a large amount of a deliverable supply in the cash market and holds a major portion of the long position in the related futures market. Thus the trader who has the long open interest corners the shorts in the delivery month. Traders who hold the short positions for the nearby delivery month are coerced into buying back their futures position at prices set by the manipulator. Once the
futures positions have been offset by delivery of the good, and normal
offsetting procedures, pressure on the demand for the cash commodity
or instrument falls. The prices fall for the commodity in the cash
market and the cornerer is left with disposing of the cash commodities
at a loss. This dilemma often is referred to as burying the corpse.

It is difficult to prove that manipulation has occurred. A
prosecutor must establish the normal price spread and explain any
distortion from the normal price spread. Once distortion has been
shown, the distortion must be traced to the alleged suspect.

Congress has written fourteen sections in the CEA that
address manipulation. None of them define manipulation. The infamous
section 3 states that manipulations are events which frequently occur.
Over the years, since 1922, few cases of any significance found an
intent of manipulation. An advisory committee to the CFTC in 1975
considered the topic of speculative position limits. The report con­
tained the following conclusions:

The idea of controlling speculators as though they were less
important or more dangerous than hedgers is basically unsound.
Speculative position limits, by their nature, point the finger of
suspicion at speculators. In fact, however, five of the eight
market manipulation cases brought under the Commodity Exchange Act
between 1972 and 1975 were against commercial operators with hedging
exemptions for at least a major part of their trading (Allen, 1981: 127).

The CEA defined speculative positions as those not considered
to be bona fide hedges. These speculative positions are subject to
limits. These limits are on the volume that can be traded daily and
positions held in certain contracts. In August 1975, the CFTC
organized four advisory committees to consider several topics. One
committee considered speculative position limits. The CFTC advisory
committee believed that speculative position limits may diminish competition and give an upper hand to commercial users because these position or trading limits do not apply to bona fide hedgers. Under current regulation, the commercial users are in a better position to exert speculative influences on prices than the speculators. Commercial users are in a situation to benefit the most from biased prices because the speculators' only interest is being right about price movement. The regulation of markets should refocus its attention toward balancing the power between hedgers and speculators (Paul, 1981). The persons most able to observe manipulative attempts are the market participants. Participants have an attitude that the market is bigger than any of the users of the market and price distortions will be corrected by the marketplace.

"I hope the CFTC will have an equally impressive staff (as the Treasury). Ours is not as big nor powerful enough" (Business Week, June 11, 1979:65). Futures markets are true economic markets. Attempts to associate speculation with gambling and with the sole participants responsible for manipulation detract from the economic benefits of futures trading. The activities of hedgers and speculators determine prices which are available to the public. This is an extremely important process useful to people in this country and around the globe. It is important that laws passed by Congress demonstrate a keen grasp of the issues. Laws which favor one side of the market or punish a particular segment ultimately will upset the competitive nature of futures markets.
Information about a market serves to reduce the uncertainty which promotes market liquidity. Futures markets aid producers in allocating their inventories more efficiently. Information about the future price of an asset affects the supply provided in the spot market. For example, a cattle producer can look at futures prices 12 to 18 months in advance and prepare his cattle for the market so as to coincide the delivery month with the best price.

Without hedging, there would be no futures trading. Hedging needs are subject to outside factors such as government stock piling which would reduce the necessity of hedging. If hedging is diminished, the usefulness of futures trading is impaired. "The chronic threat to futures trading is lack of understanding of the more subtle point that effectiveness for hedging depends upon speculation" (Gray, 1978:234). The government cannot take measures which are intended for one side of the market without this action affecting the other side.

By tracing the development of the laws regarding futures market regulation and the administration of those laws, two categories provided by regulation can be identified: (1) prevention of market distortion and (2) protection of the public from misuses of futures trading.

Market distortion refers to manipulative attempts to coerce price movement in a manipulator's favor. The government acts to prevent manipulation via a speculative position and trading limits and

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margin requirements. Manipulation involves legally proving intent and economically establishing that prices were contrived. The delivery month of a contract is crucial. All contracts carry an obligation to make or take delivery of the instrument or commodity being traded (95% of all contracts are offset prior to the delivery date). The possibility of delivery moves the cash and futures prices toward convergence as the delivery date advances. The CFTC focuses on the delivery month when looking for indications of manipulation. It assesses the size of open interest and relates it to the deliverable supply.

Prices are most likely to get out of line in a delivery month because of a delivery squeeze. What Congress has pegged as sudden or unreasonable price fluctuations most likely occur in delivery months, thus what appears to be manipulative intent are frequently sudden corrections in mistaken prices. What appears to be manipulation is not manipulation. This stereotype of price manipulation is harmful because measures often are taken by the CFTC, with pressure from Congress, to curb speculation by imposing position limits. By correcting a perceived abuse, the efficiency of the market in adjusting itself is impaired.

The major thrust of government controls has been an orientation toward curbing excess speculation. When does necessary speculation become excessive? Necessary speculation is the minimum aggregate which balances hedging positions. If, however, the hedgers are net short, the option for the speculators to be short also must be made available. Some speculators want to be short and some want to be long. This condition must be considered when deciding what constitutes necessary
speculation. When does speculation become excessive? Congress does not define excessive in the CEA. Tools are provided to curb speculation, but situations which warrant implementing those tools are not recognized by legislation.

The episode in the silver futures contract in March 1980 brought recent murmurs from Congress and the CFTC to curb speculation. The silver debacle was given widespread coverage in all major newspapers and magazines. The publicity was dubious toward futures markets. The center of publicity was Nelson Bunker Hunt who, in March 1980, was long 200 m ounces of silver futures contracts. Hunt's announcement on March 26 that he and his friends planned to sell bonds backed by silver caused Wall Street to ponder. Why did Hunt need so much cash? The doubts expressed by Wall Street spread and silver prices dropped from $50 an ounce to $10.80 in the last week of March.

Margin calls of $100 million were made by Bache Halsey Stuart and Shields to Hunt who was unavailable when the calls were made. The securities firm proceeded to liquidate Hunt's silver future position. The reaction by the financial markets was tumultuous. The Dow Jones Industrial Average shed 32.17 points on March 27 before gaining 62 points on the same day by closing time. Gold, which had been trading at $463 an ounce, rose above $500. The Federal Reserve Board contacted senior executives of securities firms to check their responses to the crisis. Congress, of course, opened investigations.

It was during that period that a prominent economist—a Harvard Ph.D. no less—was contributing greatly to Congress' better understanding of the economics of futures markets, through his incessant repetition of the phrase speculative bubble and his unabashed assertion (before several Congressional committees) that the best futures markets are those with relatively modest levels of
speculation—such as Kansas City or Minneapolis—"I speak of course of Dr. Stone the chairman of the CFTC (Stassen, 1981:31).

As a result of the silver price fluctuations, Stone called for remedies to stem the dangerous upsurge in commodity speculation. He proposed to raise speculative margin requirements sharply, impose position limits on investors in all contracts, and restrict amounts a bank or broker could loan for commodity speculation. The proposals were made in the light of the market's success.

Walter Goldschmidt said,

For me, the salient aspect of these events has been that the system worked, that the market in the final analysis prevailed; that every clearing member met its obligations and that no participant in the market, either speculator or commercial hedger suffered financially from a failure of the system itself. The market is bigger than any of its participants (U.S., Congress, Senate, Hearing, June 26, 1980:3).

Walter Goldschmidt was correct from the standpoint of competitive markets. Manipulations will be corrected by the market if left to trade out. The only person who was hurt was Nelson Bunker Hunt and other speculators seeking to manipulate the silver futures price.

Strict government regulation that punishes speculators reveals a lack of understanding of the speculator's role. Government efforts to punish speculators will reduce speculation, yet speculation improves market performance provided that speculators possess knowledge of the market. Speculators who make ill-informed decisions will lose quickly in futures trading. In their own self-interest, traders will endeavor to be well informed.

Talk of raising margin requirements has increased, along with financial futures growth. Unfortunately, the focus on raising margin requirements by government and futures market critics may outpace their
understanding of margins. For instance, *Forbes* published an article in 1981 dealing with the surge in financial futures. The authors expressed concern about the smaller margin required for futures contracts than in stock investments.

In purchasing Treasury bills, for example, a down payment of $1,000 can secure a contract on $1 million worth of bills. A similar investment in stocks with 50% margin requirement would take a down payment of $500,000 (O'Connell and Bagamery, 1981:67).

*Forbes* is incorrect in comparing futures margin with stock margin. The two are not comparable. Futures margin is a guarantee of performance of a legal contract. Both long and shorts post margin. Stock margin is a down payment for property received. The lender of the balance charges the purchaser interest on the loan. This confusion comes from those who are expected to understand the difference between commodity and stock margin. This misunderstanding is but the tip of the iceberg. Some government proposals have called for the increase of commodity margins five to ten times above current levels. (On the other side of the coin, officials murmur that, perhaps, bona fide hedging margins could be handled differently.) The leverage on futures contracts scares many government officials. Why? It stems from the bias against speculation. Speculators must be up to something!

Margins set by a bureaucracy that does not understand its function will harm the function of futures markets. Talk of raising margins sharply would have damaging impacts if higher margins became a reality. A study prepared by Robert Bear, "Margin Levels and the Behavior of Futures Prices," examined the Chicago Board of Trade's wheat and soybean futures prices from 1948-1969. The study showed that abnormal price conduct was correlated with high margin levels, not low
margin levels (Kuhn, 1981). Margins are seen as a way to control speculation. The empirical evidence, although limited, does not support margin increases to curb speculation as an effective measure to control price fluctuations.

The nature of the regulatory process also can have negative impacts on futures markets and traders of the markets. Congress set up the CFTC to be an independent regulatory agency which functions as a (1) rule-maker, (2) policeman of the futures markets, (3) District Attorney as prosecutor of alleged violators of futures trading, (4) grand jury, and (5) judge and jury to decide the case. Former CFTC chairman William Bagley said,

When the town marshall hauls you to the village justice court for a traffic violation and you suddenly find that the marshall is also the town administrator [who] doubles as the justice of the peace and gets credit for his convictions, you are in trouble (Bagley, 1980:10).

The problem with the CFTC assuming all the above functions is duality. It is difficult for the CFTC to remain impartial when defense of the commission's prosecution, responsibility for reparations, and their reputation is on the line. It is too much to expect a regulatory agency to judge fairly a defendant's blameworthiness with so much at stake.

Another problem with the regulatory process is the isolation between the commissioners of the agency and the public. As rule-makers, Congress depends upon its staff for information about topics of concern. The staff is chosen by the House and Senate members. Staff members communicate their perceptions of a situation to the rule-makers. Regulatory agencies such as the CFTC hire staffs to
combine constituent elements submitted in writing by the public. The
nature of the role of the staff member as liaison between commissioners
and the public can isolate the commissioners from their constituents.
A staff member of the CFTC commented to William Bagley, then chairman
of the CFTC, "You (as chairman) don't need to speak to the public or
to the industry (a part of the public) because we, the staff represent
the public" (Bagley, 1980:10).

This attitude can permeate the content of rules adopted by the
CFTC and cause problems. It is almost as if rules are made in a
vacuum because of this isolation inbred between commissioners and
constituents. The impact this has on futures markets is negative.
A bias by staff members against speculation can creep into rules made
by the commission. This bias will serve only to harm the economic
efficiency of futures markets if it takes the form of curbing specula­
tion.

Where does regulatory reform of the process enter in? In
order for defendants to receive due process under the law, the CFTC
should no longer serve in a quasi-judicial capacity. The CFTC should
continue its rule-making, investigative, and indictment functions but
not remain the judge. It would be preferable to allow independently
composed administrative courts be the surrogates.

The communication between the commissioners and the public
(of which the futures industry is a part) needs to be opened up.
Openness will bring understanding. As it is now in the federal
regulatory mechanism, CFTC meetings are open to the public, but staff
policy papers are kept secret. The courts further complicated an
atmosphere of openness by ruling in the 1977 Home Box case that, under some circumstances, commissioners cannot speak to the public. The District of Columbia circuit court in the Home Box case suspended the effect of a regulation because an industry official had communication with the commission after the hearings record had closed (Bagley, 1980).

This setting is not conducive to openness but suspicion. If discussion of public issues such as futures trading were further opened, understanding, responsiveness, and accountability would result. Regrettably, this reform is not impending. William Bagley was not popular with congressional members as head of the CFTC. He resigned before his term was completed. In retrospect, Bagley offered some insight into problems with current regulatory procedures and predicted the future for the CFTC.

Because we at the Commodity Futures Trading Commission are new, we have infused ourselves with the verve, the fervor, and the chemistry needed to start a new endeavor. We today are a bright, brand new shining star in the regulatory galaxy, but it won't last.

It is inherent within the concept of the "independent" commission, without accountability and without a real and ready constituency, that we will be "captured" either by the industry or by our own regulatory malaise. I don't know which is worse.

Instead of being a microcosm of social and political concerns, a commission becomes an isolated island accountable to no one—not really knowing who is its constituency.

Though Congress tries through budget and oversight hearings to provide some accountability, congressional efforts are either on a hit-and-miss basis or get bogged down within congressional bureaucracy and jurisdictional infighting (U.S., Congress, House, Hearing, March 22, 1977:161).

Bagley was confronted by the House Agriculture Committee because of this statement. After James Whitten, chairman of the committee, read
Bagley's statement into the record, Whitten's first response was to ask Bagley where he found the time to run the commission to control the exchanges.
Computerized Trading

The CEA requires exchanges to enforce rules which are subject to approval by the CFTC. The CFTC grants contract markets a license to operate only if they demonstrate competence to prevent manipulations and corners and to perform self-regulatory responsibilities. Contract markets have a primary obligation to conduct market surveillance while the commission is committed to a general oversight of futures trading activities. Under the CEA, a scheme of self-regulation is expected of the commodity exchanges. The federal regulatory agency ensures that the exchanges have adopted and are enforcing rules of trading activities.

The history of exchanges in relation to publicity has been for the exchanges to retain a low profile. This was because of the general negative attitude held by the public about futures trading. This low profile image has changed. Now the exchanges have educational and marketing programs promoting futures markets. The exchanges sponsor research, symposia, seminars, and produce films to further the understanding of futures markets.

In the 1960s, exchanges embarked upon programs to promote speculation. The concerns expressed by the exchanges in this promotion were (1) to what extent should they advance commodity and interest-rate
futures to the public and (2) what is involved in teaching the public how to speculate? Authors of futures material agree that exchanges have a responsibility to emphasize that futures trading is a zero sum game minus commission. Futures commission merchants who trade for the small speculator have an obligation to ensure traders have adequate venture capital and understand the rules of trading. The investment objectives of the speculator must be probed by the futures commission merchants.

Current issues which have an impact on speculators as well as hedgers in futures markets are (1) congressional advocates of computerized trading who encourage that it replace floor trading, (2) the start-up of the National Futures Association, and (3) contract trading fee proposals.

Critics of computerized trading claim that replacing the floor trading of futures would diminish the function of the pits as a generator of opinions. Leo Melamed said that the replacement of floor trading futures with computer terminals is equally as advantageous as eliminating Congress. The synthesis of information on the trading floor and the resulting price mechanism is comparable to congressional debates and the final vote. Both floors serve as a place for the exchange of ideas necessary for the operation of the markets and rule-making activities.

Opponents of computerized trading believe that floor traders contribute to market liquidity in the process of their discussion and trading practices. Proponents of computerized trading believe futures trading would be more efficient and contribute to market
liquidity by improving information. Presently, automated futures trading is not possible on the exchanges in this country.

**National Futures Association**

The National Futures Association (NFA) placed an application before the CFTC as a self-regulatory organization overseeing futures commission merchants and associate members of exchanges. The 1978 CEA allows a registered futures association to have mandatory membership. The NFA will relieve the CFTC of some of its paper work such as the registration of exchange members.

The NFA is under the same ethical considerations as contract markets—to prevent fraud and deceptive trading practices. In addition, it will screen applicants for membership or associate membership in the association. It will provide a centralized arbitration system for commodity futures disputes. This will lessen pressure on contract markets; the contract markets will be able to delegate authority to the association to arbitrate disputes. The NFA plans to police transactions on and off exchanges. It also plans to receive funding from annual dues payable by futures commission merchants and a contract fee of $0.25 per round-turn of futures contracts on all the exchanges.

In a surprise move in the futures industry, Robert Wilmouth, president of the Chiacao Board of Trade, has resigned to head the NFA. This will lend prestige to the fledgling association; however, the Chicago Board of Trade may become a less viable force in Washington because Robert Wilmouth was widely respected on Capitol Hill.

All eleven contract markets have automatic seats on the NFA's board of directors. To prevent domination of any contract market region,
the country has been divided into three regions. Each region will have members on the board and not more than one half the board members may come from the same geographical region. Three members not associated with futures trading will be selected from the public.

The importance of the start-up of a self-regulatory association of futures markets must be recognized. Futures industry officials long have entertained a notion that the most effective regulation will stem from sources who know the industry the best--its own members. The impact this will have on public speculators and professional speculators in the pits will be favorable in terms of understanding speculative functions. Speculators will have more confidence in regulators who know the industry inside out and do not have a history of past bias.

**Contract Trading Fee Proposal**

The contract fee proposal to fund the NFA has been receiving publicity in the *Wall Street Journal*, *Barron's*, and the *Congressional Quarterly*. The CFTC asked the House and Senate Agricultural Committees to grant it the power to assess a contract trading fee. Pressure from the Reagan administration to cut federal budgets of the agencies sent the CFTC looking for partial funding from the industry it regulates. Budget director David Stockman warned Senate and House committee panels that bills reauthorizing the CFTC for four more years would be vetoed by the President if they did not provide for a CFTC contract fee.

The CFTC has stated that the user fee would pay $22 million of the $23 million proposed budget for fiscal year 1983. The CFTC contract fee would also be $0.25 per round-turn futures contract.
Proponents of the NFA have expressed dismay with the CFTC proposal. They argue that existence of the association would alleviate enforcement duties of the CFTC. Because the FNA planned a contract fee for its funding, a similar fee assessed by the CFTC would be a duplication of regulatory efforts. The NFA officials say the industry won't stand for two assessments for one service.

The dispute between the NFA and CFTC came to a head at a Futures Industry Association meeting in Florida. Philip Johnson, chairman of the CFTC, delivered a stern message to futures officials in regard to NFA protests. Johnson said, "The protest raises doubt about the industry's commitment to greater self-regulation" ("Commodity Officials, Regulations Clash," 1982:38).

Clayton Yeutter, president of the Chicago Mercantile Exchange, likened the CFTC fee to a tax. The fee proposed by the CFTC would be paid to the U.S. Treasury not to the CFTC directly. Yeutter said, "I should think we'd be entitled to part of the defense budget in that case" ("Commodity Officials, Regulations Clash," 1982:38).

In any event, the House and Senate Agricultural Committees' bills to reauthorize the CFTC scrapped the CFTC contract user-fee plan. This action was taken in spite of President Reagan's preference for the CFTC fee. The dispute is not over yet. The House and Senate bills remain to be passed on the respective floors. It is anticipated that the bills will have a tougher time passing Congress than in the committee. A concrete decision is therefore not a present reality. Congress recesses in July; futures legislation will be voted upon between now
and July. Until the bills become law, the NFA and CFTC remain uncertain as to who will charge the fee.

**Trends in Congressional Views of Speculation**

In 1978, trading volume on the eleven exchanges was 58.5 million contracts. By 1981, trading volume had increased to 98.5 million contracts. Congress is amazed by these figures. What once was an industry of agricultural commodities dominated by a select number of traders has completely changed. Futures contracts for traditional agricultural commodities waned because of changes in the production and marketing of these commodities. The makeup of the floor traders consequently changed. A common characteristic of today's speculators trading on the exchanges is their youth. Many are baby boom kids who have been trading for less than five years (Katz, 1981).

Mike Weinberg, an 80-year-old second-generation commodities trader in Chicago has witnessed many changes over the years on the trading floor. Weinberg pointed out that one change is the degree of risk involved. This has increased dramatically in today's climate of interest rate volatility (Katz, 1981).

New financial futures contracts have developed in response to an increased volatility of interest rates on treasury bills, treasury bonds, certificates of deposit, and Eurodollars that borrowers must pay in order to secure loans. Thus new groups have entered the market to trade in futures. Some of the new participants are brokerage firms, mortgage bankers, corporations, government security dealers, and individuals.
Members of Congress, as well as the public, have problems grasping the growth in trading contracts. No one dreamed that futures would evolve into the instruments being traded and proposed.

Growth in financial futures has created a dispute between the CFTC and the Securities Exchange Commission along jurisdictional guidelines. Normally, the Securities Exchange Commission regulates fixed income securities and stocks. The CFTC has jurisdiction over all futures contracts. Battles that developed between the agencies have been quite tense at times. The two agencies recently reached an informal agreement which was overturned by a United States appeals court in Chicago. Congress stepped in and transformed the informal agreement into law written into the CFTC reauthorization bills.

The CFTC essentially will retain jurisdiction over all commodity futures contracts and options on futures including options on GNMAs and treasury bills. The Securities Exchange Commission jurisdiction includes options on securities or groups of securities (such as stock indexes). The CFTC was affirmed the regulator of futures on stock indexes subject to Securities Exchange Commission review. The agreement has the support of CFTC chairman Philip Johnson and Securities Exchange Commission chairman John Shad. There are those who believe, including some members of Congress, that the blurred lines between the CFTC and the Securities Exchange Commission will create a merger of the two.

Many members of Congress are not comfortable with the developing financial contracts and the stock index futures contracts. Representatives John Dingell, Dan Glickman, Benjamin Rosenthal, and Senator
William Proxmire are vocal in expressing doubts about the ability of the contract markets to regulate themselves. Representative Dingell especially is no friend of futures markets. Dingell wants to prohibit trading on stock index futures. He says these contracts are synonymous with gambling and may divert capital from equity markets. (Americans have $1.4 trillion long on stocks; stock index futures would be an excellent opportunity to hedge portfolios from erosion of equity capital.)

Representative Dingell is expected to oppose the House bill reauthorizing the CFTC. "There . . . [is] a very strong possibility that he will try to amend the CFTC bill to prohibit these transactions (stock-indexes) and he has also introduced separate legislation (HR 5515) to declare a moratorium on stock index trading" (Wehr, 1982:812). Dingell chairs the Powerful House Energy and Commerce Committee which has jurisdiction over federal securities law, so he wields authority in the House.

Another current issue impacting speculators is the future of the CFTC. Prominent members of Congress believe the CFTC cannot regulate the unruly futures industry. Scathing reports by the House Government Operations Committee criticized the CFTC's handling of the 1980 silver crisis. The report declared that the CFTC failed to employ the preventive and emergency actions prescribed by law.

Representative Benjamin Rosenthal said, "The Commission is too weak to monitor the industry and . . . the exchanges whose board members are often traders and brokers cannot regulate themselves" (Williams, 1982:18). Attitudes such as Mr. Rosenthal's do not help the situation.
The CFTC was created to regulate a changing industry, but members of the body which gave it life do not support it. The five rotating commission seats on the CFTC have not always been filled promptly when vacant. The President appoints the commissioners with the advice and consent of the Senate. This process has been politicized to the extent that, in 1979, the Senate Agricultural Committee warned the White House in a letter that a particular nomination was pointless because it would not confirm the nomination.

The nomination process for the CFTC is considered a long-standing game between the players. Currently, one position is vacant on the CFTC. (Two names are being considered: Michael Werner and Fowler West.) Why do these vacancies persist? An aide to the House Agricultural Committee pointed out that long delays had been common on CFTC appointments. "It doesn't get priority attention," he said (Cohen, 1982:3, section 2).

The statement by the staff member lends more insight into the matter than one realizes when first reading it. "It doesn't get priority attention." This is the same Congress that complains that the changing futures industry has caused it to struggle to gain a handle on the implications. If Congress is so concerned, why doesn't it ensure that the regulatory agency which was created by its law in 1974 is run by a whole commission?

It seems as if there is a divergence of goals. Has the political process impeded the development of the CFTC? William Bagley's testimony before the House Agricultural Committee in 1978 seems quite timely in 1982. Congressional efforts are on a hit-and-
miss basis and bureaucracy bogs them down. Congressional infighting impedes its understanding of issues it is attempting to legislate. In that the House and Senate reauthorization bills denied the CFTC imposing a user fee on contract market members contrary to President Reagan's wishes, future controversy can be expected if the bills are made into law.

The NFA is the practical solution. Congress wanted a self-regulatory body to develop in the futures industry and so stated in the 1978 reauthorization of the CFTC laws. The association is a fledgling, but it is in a position to be effective. Aided by the leadership of Robert Wilmouth, the NFA gains credibility necessary to any start-up organization. Because the futures industry is complex, reasoning implores for a regulatory body which understands its nuances.

Congress does not trust the futures industry to regulate itself, yet how responsive is it to futures markets issues? William Bagley said, "The antennae of many a Washington bureaucrat droops beyond the Beltway" (Bagley, 1980:10). Legislators surround themselves with staff members who deal with the public. Isolation results and therein lies misunderstanding. Time and time again, Congress pegs speculative activity as gambling, evil, excessive, unwarranted, and manipulative. These attitudes have prevailed in spite of all the research of economists into the workings of futures markets. The literature reveals that congressional suspicions are unfounded. As a liaison between the public and the legislators, staff members relate information from the public to the legislators. If the information
flowing upward has a chameleon characteristic, misunderstanding results in reasons for passing laws.
Chapter 6

CONCLUSION

Justice Holmes stated in the *Board of Trade v. Christie Grain & Stock Co.*, 198 U.S. 236, 247-48 decision in 1905 that

People will endeavor to forecast the future and to make agreements according to their prophecy. Speculation of this kind by competent men is the self-adjustment of society to the probable. Its value is well known as a means of avoiding or mitigating catastrophes, equalizing prices and providing for periods of want. It is true that the success of the strong induces imitation by the weak, and that incompetent persons bring themselves to ruin by undertaking to speculate in their turn. But legislatures and courts generally have recognized that the natural evolutions of a complex society are to be touched only with a very cautious hand, and that such coarse attempts at a remedy for the waste incident to every social function as a simple prohibition and laws to stop its being are harmful and vain (Rainbolt, 1977:1).

Justice Holmes' statement is as timely in 1982 as it was in 1905. The blending of law and economics is inevitable because of our increasingly complex society. Both phenomena seek to achieve the same goals: "market integrity, competitive pricing, commercial freedom, and governmental restraint" (Clark, 1978:1223). Futures markets are economic markets affected by national public interest. Attempts by the government to define its relationship with futures markets has been difficult. The government could improve its understanding of futures markets and thereby clarify the boundaries of its legislative jurisdiction. An acquired understanding of futures markets by Congress would improve the quality of legislation passed to regulate futures markets.
How can Congress better understand futures markets? There are three issues on which Congress could focus to improve its understanding of futures markets: (1) recognition of the uniqueness of futures markets, (2) understanding the role of market participants in futures trading, and (3) working toward a balanced regulatory policy.

Futures markets are unique among the economic markets. Characteristics pertaining to futures markets are fourfold: (1) futures are highly leveraged, (2) all futures contracts traded on the exchanges have daily price limit orders, a mark-to-market daily cash settlement of open interest, (3) futures operate on a no-debt basis, and (4) there is a short for every long futures contract (Melamed, 1977). These characteristics are not found in cash or equity markets.

In the past, superficial similarities between futures and stock markets have been responsible for the application of securities laws to futures markets. Some congressional members draw comparisons between stock and futures markets and, based on these comparisons, apply the same regulatory framework to the two markets. Congress should, however, examine the underlying reasons for entering stock or futures markets so that it can grasp the dissimilarities.

Congressional understanding of futures markets also could be furthered by increasing its knowledge of the roles of futures markets participants. In order to achieve this level of understanding, Congress should acknowledge the nature of futures markets. First, commodities are not futures and futures are not commodities (Bianco, 1977). Commodities are physical products. Futures contracts trade the rights to an item. Whether it is a commodity or a fixed income security is
not important; the concept is the same. There is a difference between trading an item and trading the rights of an item.

Members of Congress stated they are seeking to come to grips with the evolving nature of futures markets into financial futures. The legislative body should realize that farmers are not the only participants in futures trading. Futures trading is not solely an agricultural phenomenon. There is a wide array of participants including institutional investors, government security dealers, business corporations, financial institutions, and individuals. Participants in futures markets may have different motives in futures trading, but their actions take the form of speculation or hedging.

The role of the speculator in futures markets has been misunderstood throughout the years of futures trading. This misunderstanding lies in the history of federal regulation. Early legislation laid the base for present confusion about speculation. Consider a statement by Senator McGovern in 1973.

The people's interest in commodity trading transcends the orderly functioning of those markets and the prevention of outright fraud. For every time a speculator turns an unreasonable profit by trading futures the housewife and the consumer pay the price. And since it is the speculator, not the producer, who receives the windfall profit, the higher wholesale and retail prices do not act as a stimulant to production (Bianco, 1977:31).

Senator McGovern was mistaken. Speculators do not turn unreasonable profits. Neither are any potential profits windfalls. This kind of misunderstanding needs to be corrected. Congress should encourage members to read the research findings of economists and others knowledgeable about futures markets participants.
Congress must focus attention on understanding the true role of the futures markets' speculators. Understanding speculation would lead to an understanding of the hedging function. Members then would realize that one function cannot exist without the other. The passage of laws to curb speculation ultimately will harm the hedging function. Members of Congress can clear up confusion about speculation by examining the nature of the roles of speculation and hedging. In particular, members of committees in the House and Senate which have jurisdiction over the CFTC should educate themselves to the roles of futures markets participants.

Members of Congress should take actions to ensure that regulatory policies are balanced. The CFTC Act of 1974 granted the CFTC exclusive jurisdiction over futures trading. Congress should not allow the Securities Exchange Commission to regulate financial futures in conjunction with the CFTC. Jurisdictional infighting would result if both commissions had regulatory influence over financial futures. The CFTC and the Securities Exchange Commission should continue to work toward a compromise in regard to futures trading of options; financial futures regulation should be left to the CFTC.

A balanced regulatory policy could be achieved by congressional acceptance of the NFA and continued reliance by Congress upon the futures exchanges to perform self-regulation. Regulatory policies set by the CFTC must be made carefully, taking into consideration all potential impacts of policy on the economic viability of futures markets.
If members of Congress will educate themselves to the unique characteristics of futures markets, understand the roles of futures markets participants, and maintain balanced regulatory policies regarding futures markets, futures markets will remain intact. The resilient characteristic of futures markets should be credited for the growth and economic usefulness of futures. It is up Congress to refine the relationship between the law and futures markets.
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