National Journal

THE WEEKLY ON POLITICS AND GOVERNMENT

The Fed Study on Futures and Options

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Reprinted from National Journal, Dec. 21, 1985.
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In preparation of this article, the author wishes to acknowledge the assistance provided by Galen Burghardt, Vice President of Financial Research at the Chicago Mercantile Exchange and formerly Economist in the Division of Research and Statistics of the Board of Governors of the Federal Reserve System.

From time immemorial, predicting the future has been a hazardous occupation. Good news was universally welcome, but its failure to materialize, or its counterpart, was shabbily treated. "Behead the messenger of bad tidings," was not an uncommon reward. Little wonder then that futures and options have since their inception been an area shrouded in mystery, frequently maligned and more often than not a convenient scapegoat for unpleasant business phenomena.

Never mind that there has been little empirical evidence to support much of the fears concerning these markets. Never mind that their protagonists have always responded to antagonistic taunts with seemingly reasonable answers. Never mind that internal market studies have always supported favorable conclusions. Self servng evidence or rationale is by itself far too feeble a defense to overcome the power of beliefs founded in ignorance.

Consider then the significance of a study about futures and options at the behest of none other than the U.S. Congress. Consider then the significance of such a study conducted by none other than four federal agencies of impeccable credentials and incomparable qualifications. Consider then the value of such a study on the future life of these markets. Would it not, once and for all, shed meaningful light on this dim corner of business activity? Would it not at long last provide credible answers to age old concerns and nagging doubts? Clearly, this should be its goal.

Such was the mandate of the Futures Trading Act of 1982 when it directed the Board of Governors of the Federal Reserve System, the Commodity Futures Trading Commission (CFTC), the Securities and Exchange Commission (SEC), with the assistance of the U.S. Treasury to address the serious concerns surrounding futures and options and determine their impact on the U.S. and its business community. Moreover, in order to ensure the integrity and quality of the result, the Fed was made primary agent for the study and required to include an analysis of the work product by the other contributors.

It took more than two years to carry out this Congressional mandate and culminated in a report by the Federal Reserve Board of signal import and weightiness. Without meaning to underscore the obvious pun, its size alone is significant—its paper weight (when combined with the related margin study) is 4 pounds, 4 ounces. It thus is a report deservant of special recognition and public attention.

The report—officially called *A Study of the Effects on the Economy of Trading in Futures [and] Options*—is remarkable in two respects. The first is its scope, which covers almost every conceivable public policy question ever raised about futures and options in foreign currencies, interest rates, and stock indexes. The second is its general conclusion which is that our financial futures and option markets seem to be serving a useful social function.

What is especially surprising about the report is the amazing distance the Fed has covered over the past few years. Just seven years ago, it linked arms with the Treasury in calling for a moratorium on the approval of new futures contracts on Treasury notes and stock indexes. The CFTC obliged them, and the moratorium lasted until the Fed and Treasury could complete a joint study, which was rather parochial in its regulatory interest. When the Fed/Treasury study was released in the Spring of 1979, the CFTC was given a grudging approval to go ahead with its work. But the report then conveyed a high degree of concern that trading in financial futures—and Treasury bill, note, and bond futures in particular—could prove harmful to their related cash markets. The Treasury, for example, expressed grave concerns about possible corners and squeezes, because, to prevent the ill effects of a corner or squeeze, the Treasury might have to issue more debt of a particular type and maturity than had been planned as part of its normal debt management policy. The Treasury naturally was loath to lose any freedom in conducting its operations.

The present study, although it contains enough "on-the-one-hand-on-the-other-hand" language to make us all wish (like Harry Truman) for more one-handed economists, has none of the former grudging tone of acceptance. The change in tone is all the more remarkable because the authors of the current report were key players in the preparation of the 1979 study. The difference, then, cannot be shrugged off as little more than

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a change in political philosophy accompanying a change in administration. Rather, the men and women of the Fed have, from their own perspective, grown up with our markets. They have become far better acquainted with how these markets work, who uses them and the tools they represent. They have thus become much more comfortable with what originally appeared to be an enigmatic activity of dubious value.

HOW COMPREHENSIVE A STUDY?

To fully appreciate the significance of the findings one must first understand the exhaustive nature of the study and the thoroughness by which the Fed examined every aspect of our market place.

The first thing the Fed did, after conferring with the other agencies, was to bring together industry and academic experts to talk over the questions and to get advice on charting a course of study. The course adopted included:

1. Interviews by the CFTC and SEC staff with more than 100 financial institutions and commercial firms who participate in financial futures and options markets.
2. A broad survey of "public" participants, conducted by Market Facts.
3. A pool of the views of outside experts on various issues raised by the Congress.
4. An extensive survey of about 50 years worth of academic articles written on the subject of futures and options.
5. The preparation of several original special papers on selected facets of the questions raised by Congress.

Thus, the scope of the study was all inclusive, covering virtually every issue ever raised about these markets and examining each from every aspect. The result was a massive document which, together with the Fed's separate report on securities and futures margin, represented a most comprehensive report, to wit:

A. Basic economics of futures and options.
B. Development and growth of the markets.
C. Trading conducted and strategies utilized by institutional, commercial and professional participants.
D. Public and non-commercial participation.
E. Effects of these markets on the U.S. economy.
F. Market imperfections, unfair trading practices, financial integrity, sales practices and regulations pertaining thereto.
G. Legal restrictions on use of these markets.
H. Survey of market traders.
I. Findings and conclusions.

WHAT WERE THE FINDINGS?

In a nutshell, the study found (1) that financial futures and options do serve a useful economic purpose by providing a more efficient way to manage risk, (2) that—if anything—the liquidity of related cash markets such as those for U.S. Treasury securities and common stocks have been improved by the presence of futures and options, and (3) that there appear to be no significant regulatory problems concerning either manipulation or customer protection. (*See box*) Consider some of the specific conclusions.

Economic efficiencies: From their interviews with institutional investors, the authors learned that general price risks could be handled far less expensively by buying or selling futures or options than by trading directly in the cash market. In their own words, "... it would appear that futures and options make possible greater output per unit of productive resources, just as in the case of any cost saving technological innovation." [IV-12].

The practical importance of this is that anyone who is charged with managing other peoples' money—and this includes pension fund managers, stock and bond mutual funds, and banks—can produce higher rates of return with our markets for any given level of risk. Or, if greater stress is laid on avoiding risk, the same rate of return can be earned but at a lower level of risk. Either way, pensioners, investors, and bank depositors can be better served.

Capital accumulation and allocation: On this score, the study first sweeps aside the age-old fallacy that positions taken

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WHAT THE FED DETERMINED

(*General conclusions reached by the Joint Study*)

1. The new financial futures and options markets serve a useful economic purpose, primarily by providing a means by which risks inherent in economic activity (such as market, interest rate, and exchange rate risks) can be shifted from firms and individuals less willing to bear them to those more willing to do so. This desirable risk transfer function appears likely to spread to additional commercial and financial firms and increase in magnitude as experience is gained with these new markets and legal impediments to their use are modified.
2. Financial futures and options markets appear to have no measurable negative implications for the formation of capital. The new markets for financial futures and options appear to have enhanced liquidity in some of the underlying cash markets on which they are based and do not appear to have reduced the liquidity of any of these markets.
3. Financial futures and options contracts differ in important characteristics. Nonetheless, they have many common elements: both serve similar economic functions, markets for both are closely interrelated with the underlying cash markets on which they are based, participants in both appear to have similar characteristics, and both have similar potential for causing harm if they function improperly. Thus, there is need for close harmonization of federal regulation of these markets.
4. Trading in the functionally similar instruments under the jurisdiction of the SEC and CFTC does not appear to have resulted in significant harm to public customers or to these derivative or related cash markets. Some aberrations have resulted from arbitrage trading in index options and the securities composing the indexes. The potential for such disruptive trading in the index markets requires continued monitoring by the SEC and CFTC.
5. With respect to the issues examined in this study, the agencies believe no additional legislation is needed at this time to establish an appropriate regulatory framework. The SEC and CFTC currently have similar regulations and supervisory procedures in place in some areas requiring government oversight, and both agencies are committed to working cooperatively to establish a compatible framework of regulation capable of dealing effectively with all activities requiring such supervision and regulation.

Source: "A Study of the Effects on the Economy of Trading in Futures Options", pp. I-2, I-3.

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in futures or options markets divert investable funds from the rest of the economy. Nothing could be further than the truth; unfortunately, the tenacity with which this myth holds on is substantial and will not be quickly done away with.

In looking at the implications of more efficient financial risk management on macroeconomic variables such as saving or on microeconomic considerations such as the kind of investments society undertakes, the study found that while some effects may be possible, it is too soon to tell what they are likely to be.

Market liquidity: The study notes that "... it appears that financial futures and options markets have, if anything, generally increased cash market liquidity, perhaps most particularly, liquidity in markets for Teasury securities." [VI-35]. From the Fed's standpoint, this means that their "... ability to conduct open market operations in an orderly manner across a range of maturities in government securities appears to have been enhanced by the new futures and options contracts." It also means that "... the Treasury's ability to conduct debt management operations is similarly enhanced."

It must be underscored that the study indicates that the public benefits as a result. The improved liquidity in the Treasury securities market means interest rates paid by the taxpayer on debt incurred by the Federal government are lower than they would be without financial futures markets. And, from interviews with investment banking firms, it is clear the ability to hedge corporate bond underwritings results in a lower all-in cost of funds for the private sector as well.

Cash market price stability: Here the study finds that "Most formal empirical studies of the impact of futures and options markets on cash market prices and direct studies on the behavior of cash market prices suggest that it is stabilizing, or at least do not establish that it is destabilizing." Even so, the Fed is unwilling to conclude altogether that futures and options are unambiguously good for their related cash markets. The study concludes, instead, that "... the role of speculation as a vehicle that generally stabilizes market prices is still in question." [VI-28].

DID THE FED STUDY OVERLOOK ANYTHING?

While the study is to be lauded in most respects, it is noteworthy to record two areas where it is deficient:

Difference between futures and forwards: I believe the study could have done more in distinguishing between *futures*, which are standardized contracts traded on commodities exchanges that guaranty both sides of the trade, and *forwards*, which are customized off-exchange arrangements with no guarantor standing in between. To those who are not avid students of financial markets, the distinction may seem a bit obscure. But I can assure you the difference is fundamental.

With few exceptions, most financial catastrophies involving trading for future delivery have occurred in the forward market, *not* in the futures market. All of the troubles that government securities dealers have had over the past few years have stemmed from the repo market, which is an off-exchange market. When banks such as Franklin National in this country, Herstat Bank in Germany, or Fuji Bank in Tokyo have gotten into trouble, the trouble has come from the forward market, not the futures market.

The reason for the difference is largely one of accountability. In futures, all gains and losses are settled in cash at the end of every day. If the trades are profitable, there is money coming in, and if the trades are losing money, there is money going out. A bank's traders cannot, as a result, sweep losing positions under a blotter and hide unrealized losses from management. From the standpoint of control, therefore, futures are far superior to forwards, and I trust the bank regulators such as the Fed should appreciate this distinction.

The regulators' report card: As one might expect from students asked to grade themselves, the various agencies involved in this study have given themselves high marks. I believe they have graded themselves a bit too highly. In my opinion there are many areas where both securities and futures markets are regulated too heavily. And, I find no suggestion in the collected reports (with the sole exception of a brief ray of hope in Chairman Volcker's letter of transmittal for the Federal margin study) that the agencies plan to undo any of the unnecessary regulations they have devised, usually in response to problems more imagined than real.

The greatest danger in this respect, of course, is the regulator's ability to stifle the growth of these markets by way of regulations to prevent so-called "manipulative activities." All too often the activity involved is imagined or simply a brand new application not fully understood by the regulator whose knee jerk reaction is to mistrust it. Regulators should therefore be especially wary of making rules or interpretations which may effect the fundamental freedoms of the futures contract unless or until they have achieved full comprehension of the perceived problem. The study should have placed greater emphasis on this point.

CONCLUSION

Now that the facts are in, now that the mandate by Congress has been satisfied, how should we view the result and what can we say about the achievement? Will it provide futures and options with an environment within which to prosper or will it do little in responding to concerns which have historically inhibited their potential? I think the answers are important and generally positive.

First, a word regarding its impact on confirmed unbelievers, detractors or the unenlightened. Frankly, I doubt whether this study or any other will make a difference. For those who are fairly certain our markets are the work of the devil, the Fed report will be discarded as so much rubbish. These nay sayers are not easily persuaded by the facts nor do they often bother to examine the evidence. Thus, for the most part, this large body of negative thinking, will remain intact, believing as it always has and continuing its attack on our markets unabated.

On the other hand, for those who are charged with the responsibility of legislating our markets, the Fed study has monumental significance. It offers generally positive answers to virtually every concern posed about futures and options and provides a rationale for their favorable treatment. Indeed, the report gives reason not to impede their continued growth and provides impetus to foster an environment wherein they can expand and continue to serve the business sectors for whom they are intended.

Finally, for those of us whose daily lives are intertwined with futures and options, the Fed study represents a signal milestone. It provides us with impeccable evidence that much of what we have maintained for years is true: Our financial markets serve a useful and important economic function, and they do not undermine existing cash market structures, nor impede formation of capital. On the contrary, our markets tend to enhance cash market liquidity as well as provide an important means by which inherent economic risks can be shifted to those who are more willing to assume it. The net result is a strengthening of the economic fabric of this nation.