REGULATORY WATCH

Melamed Says Reform Shad-Johnson Now

Leo Melamed, chairman emeritus and senior policy adviser at the Chicago Mercantile Exchange, offered his views on the Shad-Johnson Accord in testimony before the Senate Agriculture, Nutrition and Forestry Committee on September 23. The following is excerpted from that testimony.

I am the author of one and one-half science fiction books. Unfortunately, it is this...qualification that is most helpful in explaining the current status of our efforts to reform the Commodity Exchange Act and the Shad-Johnson Accord.

New exchange entrants have scrambled to avoid a consistent, logical definition of exchanges that would subject them to CFTC jurisdiction. Those efforts have been matched by the efforts of SEC-regulated exchanges to avoid a long-overdue reformation of the Shad-Johnson Accord. The options exchanges are intent on denying their customers the freedom to trade a single futures contract on a narrow index or an individual equity. Under current law, public customers who want to trade a future on an equity need to go over-the-counter or do a synthetic future through the facilities of an option exchange. A synthetic future requires two transactions at twice the commission and four times the cost of a simple future to achieve an identical result.

Seventeen years ago, Shad-Johnson attempted to provide a temporary resolution to a jurisdictional conflict between the SEC and the CFTC. It is rank science fiction to apply it as a permanent barrier to innovation and growth, as has been the case. Stock index futures, the most successful of which was launched at the CME in 1982, have matured into vital financial management tools that enable pension funds, investment companies and others to manage their risk of adverse stock price movements. The options markets and swaps dealers offer customers risk management tools and investment alternatives involving both sector indexes and single-stock derivatives. Ironically, futures exchanges, which pioneered and advanced this innovation, have been frozen out.

The reasons advanced against reform of Shad-Johnson disguise competitive and/or political concerns. Today, Shad-Johnson is being used as a weapon against competition. The SEC, through statutory misinterpretation—and what the U.S. Court of Appeals for the Seventh District recently has found to be at best an "arbitrary and capricious" and at worst a "suspect" application of its powers—has denied futures exchanges the right to trade futures on stock indexes that reflect price movements in substantial market sectors. The SEC has taken the position that futures could not be traded on the Dow Jones Utilities and Transportation Averages because they did not "reflect" the utilities and transportation sectors, respectively. The aforementioned court decision has overturned and vacated that SEC decision, finding: "The stock exchanges prefer less competition; but if competition breaks out they prefer to trade the instruments themselves...The Securities and Exchange Commission, which regulates stock markets, has sided with its clients."

The Shad-Johnson ban on single-stock futures was understood by Congress to be temporary. The Court of Appeals found that the ban "was a political compromise; no one has suggested an economic rationale for the distinction." In the absence of such a rationale, Congress should lift the single-stock futures ban and allow the marketplace to decide whether these instruments would be useful new risk management tools. Many exchanges around the world trade single-stock futures; no reason exists to deny U.S. markets the opportunity to offer this product as well.

Finally, we need to deal with the groups that want to expand the exemption created by the Treasury Amendment. That provision was engrafted on the CEA to prevent the CFTC from taking jurisdiction over private transactions in foreign currencies and U.S. Treasury Securities that were negotiated between sophisticated banks and their customers. The Treasury Amendment preserved jurisdiction over any transactions in those commodities that were executed on a board of trade like the CME or the CBOT. That reservation of jurisdiction is the basis for the CFTC's jurisdiction over both exchanges.

The exchanges' proposal to reform the CEA expanded the basic principle of the Treasury Amendment and applied it to all products traded by means of privately negotiated transactions. In effect, our proposal created a bigger and better Treasury Amendment by giving the exact same exemption to all products. We were stunned when this offer of reform was met with cries of consternation. The lawyers for certain associations, dealers and banks discovered that their clients had hoped to rely upon the Treasury Amendment as an exemption to permit them to operate electronic exchanges for trading derivatives involving Treasury securities and currencies.

Such an interpretation of the Treasury Amendment is again science fiction. Nothing in the Treasury Amendment says it exempts derivatives exchanges in Treasury Amendment products.

For the complete text of Melamed's testimony, see www.senate.gov/~agriculture/mel99923.htm.