The Importance Of Being Brooksley

Editor's Note: This is based upon a speech given to the Libertarian Party of Illinois convention on April 19, 1997.

Free markets can exist in the absence of an American-style democracy; this has been demonstrated amply throughout Asia. But the opposite has never held true: a free society absolutely requires the operation of free markets.

Financial markets require consenting adults. Commercial operators can transfer their price risk to other commercials or to speculators. Speculators willingly and knowingly accept these risks in hopes of making a profit. The Commodities Futures Trading Commission (CFTC) position is these risk seekers need government protection from each other, from exchanges and brokerages, and from themselves.

The real turning point for financial markets came with the introduction of financial futures at the Chicago Mercantile Exchange. The financial futures revolution spread quickly. Currency trading is now the largest single industry in the world in terms of value transacted, it exceeds such prosaic enterprises as food, energy, and transportation.

Second, the introduction of interest rate futures allowed for innovations such as mortgage-backed securities. For example, mortgages used to be fixed-rate instruments. The Federal Reserve could constrict the housing market by raising interest rates. With all of the innovations in the home mortgage market made possible by financial futures, lenders can now offer innovative mortgages that keep the flow of credit coming into the housing market.

Third, the explosive growth of stock index futures and options and of individual equity options made it possible for investors to control their risks in investing and to create a symmetry of profit. The stock market is a positive sum game; as long as the economy grows, everyone can participate in the expansion by owning pieces of a bigger pie. The opposite is also true: in the inevitable market downturns, everyone could lose. Prior to the introduction of stock index futures and the like, the only way to protect one's downside – and backside – was to sell before the other guy. This rush for the exits created the classic negative sum game; by individuals seeking to maximize their welfare, they minimized the welfare of the group as a whole. Financial futures and options allow large groups of investors to protect themselves on the downside, and to make money when the market declines. As a result, stocks became a less-risky asset. The behavior of the bull market in equities since 1982 stands as its own testimony.

The list of market successes goes on. Trading volumes exploded on U.S. exchanges, and new exchanges were created around the world. Today the LIFFE, the London International Financial Futures Exchange, is rivaling the Chicago Merc for the title of the world's second largest exchange. Global futures markets now operate 24 hours a day. World governments and central banks have gotten the message from financial markets: get your act together, or we will punish you swiftly and publicly.

Of course, raging success spawns competition and imitation. One of the characteristics of a futures market is its standardized contracts. You will trade a fixed quantity of a known quality delivered at a specific location at a given time. Henry Ford would be smiling at this wide choice of black Model T's. Once investors and bankers and corporate treasurers saw what they could do with a black Model T, they wanted a red Corvette and a blue Lexus and gold Rolls Royce. They began creating customized risk management vehicles of their own, and create they did. The growth of these over-the-counter derivatives has exploded and now exceeds the volume of trade on organized futures exchanges. In the case of currencies, the first organized financial futures market, the volume on the exchange is now just a trivial fraction of the interbank foreign exchange market.

Just as a previous generation of bankers discovered how well they could function without government interference in the Eurodollar markets, the current generation of bankers quickly figured out how well they could function without government interference in the OTC market. As free men are wont to do, they established their own rules and practices, and set about trading without the benefit of the CFTC or anyone else. A new and clearer legal framework is necessary to continue this growth.

A bill before Congress, HR 467, (also S 257) would

1. remove the legal uncertainty from OTC arrangements in the currency and interest rate markets, although it is not clear on equity-linked derivatives, since they are handled by different laws and different agencies;
2. establish a different class of far-freer markets for the professional traders – banks, dealers, CTAs – who account for 95% of the volume done on futures exchanges;

3. provide equal treatment to options as to futures; and
4. classify "bucket shop" operators as boards of trade, and subject them to CFTC oversight; and
5. S 257 requires the CFTC do perform a cost-benefit analysis on its regulatory initiatives.

The CFTC has set about doing what any self-respecting regulator would do: declare a crisis, wrap itself in the flag, and grab for all the power it can. Despite overwhelming evidence that traders, when given a choice, will always opt for the free market, the CFTC has depicted itself as the patron saint of the abused.

How so? First, the CFTC persists in raising the specter of "bucket shops." A bucket shop is sort of like the financial version of an off-track betting parlor in which participants can gamble amongst themselves based upon prices received from the official trading world. Bucket shops used to be set up in storefronts, but now they are frequently set up in high-tech style on the Internet. Exchanges don't like bucket shops for obvious competitive reasons. Listen to Brooksley Born, Chairwoman of the CFTC at a February 27 press conference: There is "pervasive fraud" in foreign exchange futures being sold to ethnic groups, retirees, and other retail investors, and there are "people losing hundreds of millions of dollars" in this type of fraud.

Madame Chairwoman, consider this: all traders, big and small, have a right to be stupid, and a right to be greedy, and a right to be wrong. Maybe they shouldn't exercise these rights with such gusto, but if that is what they want to do, that's their choice. You can't cheat an honest man, and if someone is out there trading in a bucket shop, it's because they cannot get their demands met in the normal system.

Second, Chairwoman Born has some very strong opinions about the relative merits of free markets and government regulation. At the same press conference noted above, she had this to say about Alan Greenspan's support for futures market deregulation: "Alan is a central banker long dedicated to the free operation of market forces and against government regulation... His laissez faire philosophy naturally leads to the principle of caveat emptor, and the U.S. has ceased to operate on this philosophy since the market crash of 1929." And for good measure, she threw in the assertion that foreign regulators were "appalled" at the prospect of deregulation. As Steve Martin would say, 'Excuuuse Me!'

Third, Brooksley Born had the absolute temerity to suggest that the creation of pro-markets would lead to a series of trading disasters. Of course, she trotted out Barings Bank and Sumitomo. Madame Chairwoman, are we to believe that the current system of large trader reporting requirements and other invasions of a trader's privacy in our current system would have been able to forestall trading losses incurred through a combination of fraud and non-existent internal controls as was the case in both the Barings and Sumitomo fiascos. How well did all of our red tape prevent Robert Citron from gambling Orange County into bankruptcy, or the New York branch of Daiwa Bank from hiding a billion dollars of losses, or from Joe Jett putting Kidder, Peabody out of business, or from Salomon Brothers trying to manipulate the Treasury Note market in 1991. Nice success stories, Brooksley!

Fourth, the CFTC must believe that people check their business sense at the door when they're not being regulated. Our Miss Brooksley told the Futures Industry Association in Boca Raton on March 13 that the pro-markets proposed in HR 467 would abolish "segregation of customer funds, net capital requirements, financial reporting, margining of accounts, and special bankruptcy proceedings." This is logic only a lawyer could love! Why would anyone ever take the other side of any high-risk, high leverage transaction without providing themselves with financial surety, collateral, audited financial statements, standby credit arrangements, dispute resolution procedures, and so on? Didn't the business world figure this stuff out well before the 1975 creation of the CFTC, or should we all just reconfigure our calendars to make that the Year One?

Fifth, the CFTC regards the First Amendment as an unnecessary annoyance to be optional at best. They have held to the position that anyone, anywhere publishing an opinion on the commodity markets is acting in the capacity of a Commodity Trading Advisor and should therefore be registered with the CFTC as such. Registration is nice, but its impact upon the quality of investment advice being proferred cannot be quantified.

Let's quote that late great philosopher, Jerry Garcia: "A friend of the devil is a friend of mine." This certainly appears to be the prevailing attitude amongst our friends along the Potomac. The Securities and Exchange Commission, which has been a rival of the CFTC since Day One, and which actually had to sign what amounted to a treaty with the CFTC, the Shad-Johnson agreement of 1982, decided to ride to the rescue. In a March 17 statement to the Senate Agriculture Committee, the SEC declared "The professional market exemption would result in a dangerous and unprecedented restructuring of exchange markets into a two-tiered system that turns a blind eye to certain fundamental differences between exchange and OTC markets, and the crucial role exchanges play as price discovery mechanisms." This would "seriously impair" liquidity

for small business and retail investors. The SEC is arguing that the 95% percent of volume done by large traders should be subordinated to the needs of the 5%, and oh, by the way, it has been documented for a long time that 90% of small speculators wind up losing money. The occasional $100,000 jackpot in cattle futures by first-time traders is actually quite rare.

The SEC later tipped its hand with the real objection: since pro-markets would open the world of equities trading up to the innovations already common in currency and credit markets, new products, such as the currently-prohibited futures on a single stock, would become possible, and this would, according the SEC's head of market regulation, "upset the regulatory balance between the SEC and CFTC." We wouldn't want that, now, would we?

We stand at the threshold of an age where markets have triumphed. Technology is making it cheaper, faster, and more efficient for traders world-wide to gain the benefits of centralized price discovery with or without a trading floor with open outcry. It is incumbent upon all of us in the risk management industry to recognize this tidal force. Let's do what the semiconductor industry did: always place the interests of the customer first, compete with our own product lines, stay paranoid, and decline offers of government "help."