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Administrative Office
c/o Professor George Kaufman
Loyola University Chicago
820 North Michigan Avenue
Chicago, Illinois 60611
Tel: (312) 915-7075
Fax: (312) 915-8508
E-mail: gkaufma@luc.edu

Statement No. 163

For Information Contact:

Franklin Edwards
212.854.4202
Roberta Romano
203.432.4965
Hal Scott
617.495.4590

Statement of the Shadow Financial Regulatory Committee

on

The Regulation of Derivative Instruments

September 25, 2000

Congress is reconsidering the regulatory framework for derivative instruments under the Commodity Exchange Act (CEA) as it moves to reauthorize the Commodity Futures Trading Commission (CFTC) this year. One component of the reauthorization legislation will concern the agreement recently reached between the CFTC and the Securities and Exchange Commission (SEC) to remove the current prohibition on equity derivatives in the CEA, which are contained in a provision known as the Shad-Johnson Accord. A second component is the recommendation of the President's Working Group on Financial Markets that legislation be adopted to clarify that over-the-counter (OTC) derivatives are not subject to regulation by the CFTC under the CEA.

The Shadow Committee endorses initiatives to reduce the regulatory burden on derivatives markets generally. The Committee recommends that Congress adopt an approach that permits futures on individual stocks and narrowly based stock indexes to be traded on either a futures or a stock exchange. Derivatives traded on a stock exchange would be subject to SEC regulation. Futures traded on a futures exchange would be subject only to CFTC regulation. The SEC-CFTC agreement envisions harmonization in regulation between securities and futures exchanges; the Committee does not believe such harmonization should be a precondition for repeal of the Accord. The Committee also recommends that over-the-counter derivative transactions between sophisticated investors be exempt from CFTC and SEC regulation.

Equity Derivatives

The Shad-Johnson Accord prohibits futures contracts on individual stocks and narrowly-based stock indexes. A potential concern in repealing the Accord is that these transactions will be subject to manipulation and insider trading abuses. The Committee believes that these concerns are not sufficient to prevent repeal of the Shad-Johnson Accord. Individual stock futures are traded uneventfully in other locales, such as Australia and Hong Kong, without any adverse impact on the securities markets; and the longstanding trading in individual stock options has shown that concerns that derivatives trading in individual stock destabilizes securities markets is unfounded. While manipulation has not been of significant concern in financial contracts generally, the same institutional safeguards used by option markets, such as volume requirements for underlying stocks, can be implemented without difficulty by exchanges for futures on individual stocks. In addition, the contracts can be cash-settled and position limits can be established to further lessen the possibility of market manipulation. With respect to insider trading, regulations applicable to individual stocks can and should be extended to individual stock futures.

The Accord was a political compromise of an interagency jurisdictional dispute that has restricted product competition at investors' expense. Adoption of the CFTC-SEC agreement, which would extend much of the SEC's regulatory regime into derivatives regulation on both futures and stock exchanges, including authority to veto futures exchanges' products, would simply sustain that structure. The Committee views any SEC regulations that affect the competitiveness of stock exchanges compared to futures exchanges, such as transaction fees or margin requirements, as a matter for the SEC to reexamine in conjunction with the stock exchanges' concerns. But the Committee notes that margin requirements, for example, serve different functions on futures exchanges (where they are a protection against counter-party default) than on securities exchanges (where they are supposed to reduce investor speculation). Therefore, simply applying SEC rules to futures exchanges should not be made a precondition for repealing the prohibitory Accord.

Over-the-Counter Derivatives

In the OTC derivatives market there is legal ambiguity over whether products such as swap contracts are exempt from regulation by the CFTC. The question is whether the exemption of OTC derivatives from CFTC regulation raises investor protection or systemic risk concerns. The Committee's view is that it does not. The Committee believes that there is no reason to regulate further OTC derivatives (individually negotiated derivatives contracts) that are sold or purchased by sophisticated investors (such as "eligible contract participants" or "qualified investors"). OTC instruments are acquired by sophisticated investors in directly negotiated transactions, and contract law provides the parties with adequate protection against fraud. The dominant players in the OTC markets are banks, and federal banking regulators already exercise regulatory control over those institutions and their derivatives activities that renders unnecessary additional regulatory oversight of the OTC market. The Committee, therefore, recommends clarifying legislation to exempt OTC derivatives bought and sold by sophisticated investors from regulation by the SEC and CFTC. The Committee recognizes that the exemption of OTC derivatives from CFTC regulation raises some substantive competitive issues about the structure and regulation of derivatives products traded on exchanges. The Committee believes that serious thought should be given to reducing federal regulation on all derivative products that are bought or sold by sophisticated investors, whether traded over-the-counter or on an exchange.