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secretary

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Subject: CFTC Regulatory Reinvention Proposal

The following article concerns the CFTC proposal for "Regulatory Reinvention" cited in the Federal Register under 65FR38985/986 and 65FR39027.

PLEASE POST THIS in the CFTC Public Comment file.

CFTC Deregulation: The Long And The Short Of It - (4/14/00)

COMMENT

ABSTRACT

For the purposes of lessening regulatory burdens on the futures industry and reducing the costs of policing the futures markets, the CFTC (Commodity Futures Trading Commission) has proposed new rules. (1) There are a number of facets to this proposed CFTC deregulation which is largely geared at preventing new exchanges and OTC providers from pulling the rug out from under the existing regulated exchanges. (4) One of the more troubling aspects of the proposal is that it would allow the exchanges to decide if non-commercial (retail) traders would be allowed to trade in certain less regulated "commercial" markets. And when they are allowed, government approved "intermediaries" would be required (which may involve higher commissions). In the smaller picture, this could have a large negative impact on retail trading. In the larger picture, this could have a negative impact on the world economy for many years into the new century.

Below it is surmized that the underlying problem in today's markets is due quite simply to the imbalance between long-term traders and short-term traders or, the "tortoises" and the "hares," if you will. The market outlook of these trading "animals" (bullish or bearish) is irrelevant. But while the average trade duration of commercial trades may exceed that for retail speculators, dividing up the markets along this arbitrary and discriminatory boundary as a long-term solution is to not fully grasp the underlying roots of the above mentioned market imbalance and the direction in which it will take the free markets if not properly checked. Several problems with and alternatives to the separation of these symbiotic and synergistic trading sectors are also described below. These alternatives are aimed more directly at controlling the above root-cause imbalance without segregating based on trader status. The result would be a freer, more competitive economic state that would ultimately benefit all parties.

Ironically, what this market imbalance points to is that for the CFTC and the SEC (Securities and Exchange Commission) to allow unrestrained decreases in trade duration due to electronic trading means, is actually to restrain free trade due to the proportional decrease in long-term speculation that must follow. (The reason for this will be explained below). This poses a serious threat to the free market system. For with a large continuous decrease in long-term market speculation, volatility increases as price

stabilizing forces are utterly lost and business and consumer costs skyrocket. This would lead to increased global inflation, hiked interest rates and reduced economic output. In the worst case, smaller economies could collapse. Because of this possible negative end result, it is concluded that any rational overhaul of the current market structure should fully understand and account for these underlying market forces. It is not apparent that the new CFTC proposal does.

RETAIL TRADING IMPACT

When Senator Peter G. Fitzgerald (R-IL) recently asked if the proposed CFTC deregulation wouldn't lead to a larger bid-ask spread for retail traders, Federal Reserve Chairman Alan Greenspan offered that arbitrage would most likely prevent that. (2)

If the volume is high enough in both the retail and commercial market, Mr. Greenspan's response certainly sounds reasonable. However, the CFTC proposal does not mention any volume requirements which the exchanges must follow when deciding if non-commercial traders would be allowed to trade in commercial markets. It only mentions some guidelines regarding which types of markets the commercial-only markets would be restricted to. (1) And judging by the commission's recent acceleration in exemptions (3) and the pro-deregulation stance of the new CFTC chairman, William Rainer (4), it is not unreasonable to extrapolate and picture some point down the road when just about any market might become eligible for commercial-only status. So who can say for sure that some resulting retail market volumes in the future won't be extremely thin with higher bid-ask spreads? If this occurs, then for the retail trader it would be analagous to NASDAQ dismantling its new computerized trading network, and returning to days passed when it was much more difficult for retail traders to get a competitive fill due to market segmentation. And although there will still be limits on position size, to the extent that retail market volumes are decreased from today's "free" market volumes, the risk exposure to price manipulation and distortions, legal or otherwise, will still be increased for the retail market trader due to the increased controlling power of larger interests when volume is lower.

Also, there don't appear to be any guidelines mentioned that would require both the commercial and retail markets to have identical contract specifications. What if the commercial contract sizes are allowed to be significantly larger than the retail contracts? Due to the larger risk, this could shut out many retail traders from commercial contracts even if they are given the choice to trade those markets. And will the quotes in both markets be required to be simultaneous? If not, arbitrage will be hampered. And even if liquidity is high, certain other differences in the contract specifications could lead to large differences between the two market prices, including differences in both the bid-ask spread and volatility. For example, suppose the daily limits in the retail market are set smaller than in the commercial market as a means of protecting the retail trader. During a large price drop, the commercial market price could roam down freely while the retail market is locked limit-down for the day. And if the commercial price finds a new price level well below the retail market's lock-limit, locking the retail market will be a meaningless exercise since the retail price will keep stepping down daily until it finally reaches the new commercial price

level. In other words, the voices of the retail traders in determining the new price could be largely locked out for several days, placing control of the new price level almost completely in the hands of the commercial market. Not only would this remove sentiment diversity from price discovery, it could lead to what some might construe as simply a new form of legal price manipulation. In addition, it should not be assumed that the retail speculator is always going to react faster to abrupt market changes than the non-retail sector. Recent declines in the U.S. stock market proved that this is not always the case.

Furthermore, in the above scenario a smaller retail daily limit could lead to a false sense of security for fledgling traders, leaving them "unarmed" and at the complete mercy of the commercial market. So although separate retail and commercial markets might allow the CFTC to protect retail traders from illegal market manipulators more efficiently, existing market safeguards could be rendered useless in the process.

Another factor which Mr. Greenspan did not consider in his response is that the retail market may have a different proportion of long-term and short-term traders than the commercial market. The retail market, for example, might become overloaded with electronic day traders. In this case, there may not be enough arbitrage volume in both markets for the two intraday prices to track that closely, possibly leading to higher short-term volatility in the retail market. Regardless of the bid-ask spread in this case, medium and long-term retail traders would be forced to trade in this more risky, less profitable environment or leave the trading table all together. This could act to further increase short-term retail-market volatility in a vicious cycle until the retail market becomes nothing more than a tool for the day trader. The spread size in this case wouldn't matter since the price would be all over the board anyway. This scenario would place an undue risk burden on the retail trader that could far outweigh the risks due to illegal price manipulation which the new CFTC market structure would supposedly be more capable of detecting. This added risk coupled with the already higher risk due to increased short-term "electronic trading" volatility would place the retail trader at a severe disadvantage in the market. Feeling relegated to "the back of the bus," many may opt out of the given market. Others might only be forced out after financial ruin.

The exchanges would most likely decide whether or not to allow non-commercial traders to trade in the commercial markets based on whether or not introducing non-commercial volume to those commercial markets will increase their profits. This may rarely work out in favor of retail traders. This is because retail trading tends to be shorter term compared to commercial trading. And with a decrease in short-term trading volume, commercial traders will be able to increase their positions due to the lower short-term volatility risk. In many instances, these large increases in commercial volume could far outweigh the loss in exchange profits due to excluding non-commercial traders. Granted this would probably only occur in cases where the retail market price is incapable of closely tracking the commercial pit price. But if the retail volume is low in these cases, it may quickly dry up to zero as retail traders look for greener pastures and tighter spreads. So if not properly regulated or "deregulated", retail traders could conceiveably be locked out of certain markets entirely.

GLOBAL ECONOMIC IMPACT

Another worry is that Senator Richard G. Lugar (R-IN) recently stated that Congress has three months to pass a deregulation bill in order to get it done in this election year. (2) This may not allow enough time for experts to properly review the ramifications of the proposal. And since foreign market regulators look to the U.S. as a model, any serious flaw in the new design could have global economic repercussions for years to come. Core changes such as those proposed demand multiple, independent simulation studies to determine the range of economic impact before implementation. Instead Congress is playing a round of Beat-The-Clock. It took the FCC (Federal Communications Commission) years to nail down the HDTV (High-Definition Television) design standard. And changing the design of the futures market structure could have much more serious consequences for the world's markets than that relatively simple microcosm.

In addition, if regulators in other countries follow suit, they may have a more relaxed view as to which markets would be eligible for commercial-only status. And regardless of their initial stance, even if only one country eventually edges towards less liquid markets becoming eligible, each of the others in this string of dominoes will feel compelled to follow in order to compete effectively. So regardless of the initial stance of the CFTC on this critical issue, their hand could be forced at a later time by foreign market regulators. So it is not at all unreasonable to consider that eventually all markets might in fact be eligible.

Meanwhile, doesn't the FTC (Federal Trade Commission) figure into this at all? The idea that a diverse sector of traders could in some cases be completely shut out of a market as described above, has got to be a violation of the Sherman Act since that would have to be considered an unreasonable restraint of trade. Yet it is not apparent that the exchanges will be required to abide by this model code of the free market system in this regard. And to not do so could have serious economic implications. For the retail trader offers a diverse speculative perspective on the market. If that sector of investors is left out of the puzzle, the market could become imbalanced to the long-term side. Long-term volatility could increase wildly, unchecked due to the decrease in diversity from removing retail market speculation which tends to be over a shorter term. This is simply the logical outcome when the law of supply and demand is applied. Large price swings like the recent one in crude oil could become much more common. And only the strongest economies of the world might survive when several of these wild swings eventually occur coincidentally. The inherent risk of decreased tax revenue alone makes any cost savings in market policing under the new structure an extremely poor tradeoff. Furthermore, for the CFTC to allow an increase in trade restraint so as to simplify policing would be analagous to the FTC allowing a monopoly to force private competitors out of business since private companies would be more difficult to police. Obviously, this is not a sensible policy.

Even if the exchanges were disallowed from excluding retail traders from the commercial markets, the requirement of the intermediaries will still have a measureable effect on decreasing retail speculation and increasing long-term volatility. However, this more minimal effect might not be

all bad since increased electronic trading has weighed heavily on increasing short-term volatility in recent years. This brings us closer to the heart of the problem. Besides policing the markets, shouldn't the goal of the CFTC and Congress be to design a market structure whereby long-term and short-term trading are reasonably balanced so as to maximize price stability, and achieve this without unduly excluding market participants? Afterall, the efficiency of hedging will continuously decrease if market volatility is allowed to continuously increase. Without any price stability, having all of the liquidity in the world is meaningless. And the more stable prices are, the more smoothly the world economy as a whole will run. This leads to less social and political unrest and higher rates of economic growth the world over. In addition, it is reasonable to conclude that maximum price stability would occur at a point of minimal trade restraint which would be a point of maximum market freedom.

If you have trouble believing that longer term trades add short-term stability to the price, ask yourself why the volatility of the equity and futures markets has climbed so rapidly over the last few years. The obvious reason is the boom in both electronic communication and electronic trading. Now you can be stopped at a red light and dial your cellular and sell 20 contracts. Or you can be waiting at a "Don't Walk" sign, or in a restaurant waiting for your steak and fries... The point is, these electronic improvements have led to a shift in market volume to ever shorter trade durations. There is much more impulsive trading while in the past, people would tend to ride out the peaks and valleys since they didn't have efficient means to check the price more than once a day, if even that often. In addition, this electronic revolution has led to a larger number of traders choosing to trade on a shorter term, including day trading, and even automated day trading methods.

So suppose in 2050, computerized trading systems and distributed network technology exists to allow the growth of a new breed of trader dubbed the "nanosecond trader." In the interests of free trade and liquidity, should the governments of the world allow this new breed to flourish? It would seem insensible due to the decrease in price stability. The instability follows because shorter and shorter larger-sized trends would be allowed to develop as volume due to shorter and shorter term trades is allowed to grow ever larger. The problem generated by this scenario is that there is a higher cost of speculating over the longer term when the risk due to short-term volatility is higher. This reduces long-term speculation by slowly compressing it down further in time which leads to decreasing trader diversity. Taken to the extreme, this geometric migration rate would eventually result in all speculators becoming day traders thereby undermining price stability, the very goal of trading. Even longer-term hedge traders would have to become more speculative in their approach since in this environment hedging would have a reduced impact on controlling risk. That is, higher price volatility still leads to increased business costs for hedgers. This would tend to decrease the average duration of hedge trades as well. So the resulting market could become more volatile over the short-term than simply picking a price out of a hat. For example, what is now a year's worth of price changes might be squeezed down into one week. And left unchecked, this market structure effectively restrains longer term trading since the risks of doing so increase as short-term volatility continuously increases. So it is

concluded that this "monopoly" on short-term trading would not be in the interests of a free market economy since it would in fact not be a "free" and diverse market. Granted, the above may be a worst case scenario. However, in any design endeavor, it is necessary to consider the worst case in order to achieve a reliable result.

Thus far, the only driving force behind the electronic trading revolution appears to be to increase profits by increasing volume with little regard for price stability. And although the prospects of ever increasing volume due to shorter and shorter-term electronic trading may appear on the surface to be a bottomless gold mine to the industry, in reality there are only finite limits to these increases which any given economy can withstand. And attempts to run the economy near these limits will be highly inefficient, resulting in more "bust" periods that erode overall trading volume in the long run. Because of this, these limits are not at all likely to be the peak operating point for the economy or for trading volume. So although electronic trading may help increase liquidity significantly, a definite requirement for stable prices, it accomplishes this without regard for a second requirement, balanced long-term and short-term interests. And a large imbalance to either side could be significantly worse for price stability than low liquidity. Ironically, if this balance was reasonably maintained such as with one of the methods described below, the growth rate of market volume would very likely be faster and more sustainable.

ALTERNATIVE SOLUTIONS

So won't the CFTC and SEC (or FTC) at some point need to determine a minimum delay for electronic order routing to limit this "artificial" increase in short-term volatility exemplified above? Some speed limit would seem to be in order since advances in computers will always outpace economic growth. Already the electronic trading frenzy has increased short-term volatility way beyond the norm and thrown off the delicate balance between the "tortoises" and the "hares." If left unchecked, this balance will continue to spiral out of control as medium and long-term speculators slowly shorten the duration of their trades or exit the markets entirely. Yet, the CFTC proposal leaves one wondering if they've considered this underlying problem even five years ahead, much less 50. Let's not wait until zero-hour as with the Y2K issue. Computer and communication technology progresses far too rapidly to allow this problem to be ignored until the next round of deregulation.

It seems clear from the above example, that some new control mechanism will be required to achieve a reasonable balance between long and short-term trading, in order to prevent runaway price volatility from effecting the smooth operation of the economy. Since the free market is not able to control this imbalance, the government must or it will be sacrificing its own tax revenue and the security of the nation's economy. This is simply analagous to the Fereral Reserve's throttling of the economy by varying interest rates. That action helps smooth out economy rough-spots that might completely overwhelm smaller business operations and lead to a reduction in economic diversity. So to instead promote this diversity increases competition and leads to a freer, less-restrained economic state. After such incredible sustained economic growth in recent years, how many are still arguing with Mr. Greenspan on this issue?

So suppose an increase in short-term volatility beyond a set threshold was greeted by an artificial increase in the bid-ask spread. The prices in the spread could be moved up or down based on the volume lining up on each side of the market, while the size of the spread would be controlled by the volatility. This would act to automatically decrease short-term trading volume whenever the volatility reached the extreme, acting to stabilize the price. Given the state of computer technology, this would not be difficult to implement in electronic trading. Plus it would tend to act more efficiently on the root of the problem than the current daily limit method, which would instead result in ever more frequent trading halts and decreases in liquidity. Thus far, larger price changes and subsequent trading halts have not become ubiquitous within the course of a single day. However, without the CFTC accounting for this forseen problem ahead of time, that day will come.

Another idea to consider would be to have a separate pit for contracts held less than a prescribed period (such as one day or one week). Or allow this period to be variable so as to maintain a specific percentage of volume in each pit. All retail and commercial contracts could interact under this proposal, but if a trader wishes to exit a position before the period is up, the order is automatically routed to the short-term pit where all trades originate. This would create a separate more volatile short-term pit price that day traders could take advantage of, and a less noisy long-term pit price. Although long-term traders would pay some penalty at the outset of a trade due to the volatile short-term pit entry price, once committed for the long term, they would enjoy less short-term risk due to the reduced short-term volatility in the long-term pit price. Also, the open and close prices in the two pits would tend to track more closely as short-term pit day traders offset their speculations allowing arbitrage to take over. This would allow long-term traders to enter the market at those points with minimal short-term volatility penalty. In addition, a minimal electronic order delay as alluded to above could also be imposed to place some upper limits on the short-term pit noise.

Although the short-term price would be more volatile, its average would simply migrate to the long-term price (not vice versa) because the short-term pit transactions would not be capable of effecting the long-term price. In effect, every trader's short-term market stimulus would be filtered into the short-term "noisy" pit price. This would be somewhat analagous to spread trading in the sense that it is, in effect, a market within a market. By contrast, the CFTC proposal could ultimately result in the retail market becoming this shorter term "noisy" pit, which would greatly increase the short-term risk burden for all retail traders rather than for all short-term traders, where the line should logically be drawn. And while this might prove to be advantageous to the commercial market in the short term, in the long run it will become a disadvantage for everyone in the economy due to the resulting decrease in speculative diversity and price stability.

The key to the implementation of this two pit structure would be in determining the short time period which strikes the optimum balance between long-term and short-term interests in the long-term price for maximum price stability overall. That is, the optimum tradeoff between short-term volatility and trader diversity. This would be the

responsibility of the CFTC to determine. In this model, the more stable long-term price would also be accompanied by increases in both long-term and short-term liquidity, which would be the clear sign of a freer, less restrained market, and would greatly benefit the exchange and brokerage industry as well as the economy as a whole.

Furthermore, with the above method there would be no chance and no need for any segment of the trading public to be arbitrarily excluded from any market as with the current CFTC proposal. For it is only logical that a method that restrains trade less leads to a freer, higher volume market with more stable prices that benefit everyone across all sectors of the world economy. And although this structure might be more costly for the CFTC to police, the added tax revenue due to a more stable economy over the long run would offset that cost thousands of times over. So clearly, this is not an area which Congress should be looking to skimp on by promoting a structure which reduces policing costs. Afterall, it is illogical to design a market structure soley around its ability to be policed, especially if significant market freedoms may be sacrificed in the process. It should instead be designed in order to maximize price stability and liquidity with minimal trade retraints. That chosen design may indeed cost more to police, but increased economic stability will more than cover the cost. And why should the retail trader be forced to pay additional "trading" taxes due to added restrictions when they pay their federal taxes too, just like the commercial participants, and when their voices are also needed in the pits to maximize price stability? So instead of choosing a regressive design that reduces market freedom and will in the long run be detrimental to all, why not instead choose a progressive design that will benefit all members of the trading community as well as the world economy as a whole?

CONCLUSION

The U.S. government has a serious responsibility to the world economy which it shouldn't take lightly by racing through the implementation of a new market structure, letting potentially serious problems slip into blind spots and without allowing time for the experts to properly study the problem and respond. If it was desired to implement these changes by 2001, Congress should have started on these changes several years ago.

The conclusion of the above is that markets should not be separated based on trader status. To do so is discriminatory and not ultimately in the interests of the free market system or price stability, both of which must always remain in the cross-hairs of any proposed CFTC changes. Furthermore, the main topic of discussion today by the CFTC and the SEC should be about the potential price destabilizing aspects of electronic trading and how to deal with them fairly and effectively. Instead, the topic is how to deregulate the futures markets, an action which will only accelerate that root-cause problem further. Sooner or later the root of the problem must be dealt with. To do so ahead of time would promote growth and prevent unnecessary economic hardships.

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