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COMMENT

Mandating the natural

As US exchanges increasingly go public their governance has come under regulatory scrutiny

oting that the world's major derivatives markets are going public and for-profit, Commodity Futures Trading Commission (CFTC) has proposed to impose upon the converted shareholder companies two new requirements. First, at least half of the members of the governing board must be independent of the organisation, that is not on the payroll, not users of the market not significant suppliers or advisers, and not having any other "material relationship" with the market. Second, control of the exchange's rule enforcement programme – traditionally known as "self-regulation" – will reside entirely with these "public" directors.

The US regulator asserts that these changes will reduce conflicts of interest that it perceives to exist now that the exchanges are investor-owned, profit-making ventures that might be more likely to subordinate their ethical obligations to commercial ambitions and the expectations of Wall Street. However, that premise bears examination.

Self-regulation was first adopted without governmental compulsion by exchanges that were owned by their users. These markets were operated on a break-even basis because the members had no incentive to, in effect, overcharge themselves so that the entity could show a profit. Any profit that was recognised could not be recaptured by the owner-users except after being double-taxed, at the exchange and again upon return.

The most valuable aspect of membership, therefore, was not the price of a trading seat itself but rather the opportunities it created to make money in the member's own business operations as a trader, broker, clearer, advisor or the like. Self-regulation was adopted to ensure that no one would inflict upon the exchange a scandal so severe that the members' own businesses would suffer. An analogy might be the stake that airlines have in airport safety.

However, for-profit exchanges owned and controlled by non-users operate under a different dynamic. Now, the shareholders have a far greater interest in the value of their shares because it is their only hope of gaining from their investment. They will want to maximise revenues, typically a function of accelerating trading volumes, while minimising costs – of which self-regulation is one of the biggest – so that their shares appreciate in value and Wall Street keeps the market on its buy list.

Investors are not constrained, as were members under the previous structure, by concerns about the impact of a market crisis on other business interests they hold. Indeed, the CFTC proposal would disqualify them from service as public governors if any such interests existed.

Some have asked whether CFTC is proposing to place control of the exchanges in the hands of the very people who are most likely to suffer the conflict of interest that it fears, and a case for that conclusion is certainly there. But it is too late anyway: every enterprise that is controlled by outside investors with a profit-making purpose will have the instincts to inflate revenues and strangle costs. Only an effort to reverse the trend for going public would address this issue but the conversion by exchanges is too far along for that. The train has left the station and the CFTC proposal, in effect, simply institutionalises the inevitable.

It remains to ask, however, whether CFTC is even asking the right question. Self-regulation is unique, with very few industries offering anything like it; it is not even a universal feature of the financial community. Nothing like the elaborate self-regulatory structure for the traded markets exists, for example, in the banking or insurance businesses. The same can be said for most other segments of the US economy, and most of that seems to be good corporate citizens most of the time. Rather than struggle for ways to keep this concept relevant in a changing world it might be best to simply acknowledge that it was a good idea in the old days but is no longer reliably workable.

If that outcome is unthinkable to some, it must be asked whether we can at least agree that a rules enforcement programme imposed on market users who are barred from any role in its operation can be called self-regulation any longer. Considering that CFTC uses that term or variants of it no fewer than 166 times in its proposal, even a consensus on this narrow point would be an accomplishment.

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