Current & Future Issues:
How Do We Cure (not Kill) the Golden Goose?
(Proposing a Policy Research Agenda)

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Direct and Indirect Futures Markets Participants

- Financial Intermediaries
  - Banks/Broker-Dealers
    - Derivative Product Subs
  - Commodity Traders
    - Futures Merchants
    - Physical Commodity Merchants
  - Professional Arbitrageurs/Investors/Speculators
    - Hedge Funds/CTAs/CPOs
    - Pensions, Insurers

- Producers

- Consumers

Operative Questions

- What is the appropriate role for regulation?
  - Enforceable property rights regarding the division of “surplus”
  - Institutional/organizational frameworks
  - Industry standards/practices
    - Transparency and disclosure
      - Too much vs not enough information, transparency, disclosure
  - Social planning does not necessarily maximize social welfare (“The Problem of Social Cost”)
    - The problem with “one-size fits all” regulation is that it actually obscures informative signals (quality, etc.), resulting in market failure

- How to harmonize appropriate market mechanisms with appropriate regulation?
  - Coase, Stigler, Posner, Miller, Knight, Viner, Stiglitz, etc.

Related Relevant Domains of Inquiry from Economics

- Industrial Organization Questions
  - Optimal Scale and Survivorship
  - Cost Structure and Imperfect Competition
  - Property Rights, Allocation/Rationing, and Regulation (Law and Economics)
  - Social Cost: Private vs. Public Benefits
    - Positive vs. Negative Externalities
- Corporate Finance Questions
  - Principal-Agent Issues
  - Governance and Incentives
  - Costly Monitoring and Incomplete Monitoring
  - Optimal Leverage, Capital Structure (Debt contracts), and Verification
  - Real Options, Managerial Economics and Competitive Strategy
- Financial Intermediation Questions
  - Risk sharing and bilateral credit agreements
  - Asset/Liability Management
  - Risk management and Borrowing Capacity: Risk-Based Leverage
- Asset Pricing Questions
  - Limits of Arbitrage vs. Market efficiency
  - Common factors in returns
  - Market microstructure

Industrial Organization Issues

- Optimal Scale and Survivorship
  - Financing Advantages versus Investing Advantages
    - Paradox of low-cost funding
- Cost Structure and Competition
  - Capacity
- Property Rights, Coordination, and Allocation/Rationing
  - Harmonizing Regulation with Market Mechanisms
- Social Cost: Private vs. Public Benefits
  - Positive vs. Negative Externalities
    - “Excess Volatility”
    - Over- (Under-) Investment

Corporate Finance Issues

- Principal-Agent Relationship
  - Governance and Incentives
    - Conflicts of Interest
    - Costly Monitoring and Incomplete Monitoring
    - Managerial Real Options
    - Embedded Options within Compensation Agreements

- Optimal Leverage/Capital Structure
  - Debt contracts
  - Verification

Financial Intermediation Issues

- Risk sharing and bilateral credit agreements
  - Risk-bearing Capacity: Financing vs. Insurance
  - Collateral (Asset Volatility) Constraints
  - Counterparty Credit Exposure

- Asset/Liability Management
  - Investment horizons
  - Strategic/Predatory Trading
  - Systemic Effects of VaR-Based Risk Policies

- Risk management and Borrowing Capacity
  - Risk-Based Leverage

- Asset Substitution
  - “The Paradox of Liquidity”
  - Adverse Selection
  - Moral Hazard

Asset Pricing Issues

- Limits of Arbitrage vs. Market Efficiency
  - Common factors in returns and cross-market correlation
  - Market microstructure
  - Supply of (Demand for) Risk-Bearing Capacity
  - Access to Credit
  - Hedging Demand

- Boom/Bust Cycles
  - Asset and Credit Bubbles
  - Contagion and Information Cascades
  - Strategic/Predatory Trading

- The Impact of Liquidity Risk on Asset Prices

- Price Transparency for Illiquid Assets

- Portfolio Optimization and Model Selection in Imperfect Markets

Proposed Research Agenda

- Objective: Clarify, articulate, define and operationalize a problem with no simple solution
  - Coherent Taxonomy
  - Consistent Terminology
  - Quantifiable Measures, Thresholds, and Signals

- By applying Multi-attribute Decision Analysis and Real Options Theory to the Theory of Financial Intermediation (Merton)
  - The role of every financial intermediary is minimum cost production of (nonredundant, contingent) financial claims
    - Optimizing risk-bearing capacity (Risk-Based Leverage)
  - The practical problem that every financial intermediary faces: coordination through governance/incentives (compensation, etc.) and capital structure the interactions between risk management, hedging, financing activities
  - Financial intermediaries are bundles of contracts with imbedded contingent rights and obligations (claims, options), which determine each financial intermediary's unique cost structure
  - How do these interact within the legal/institutional framework?
    - Within the firm?
    - Between firms?
    - Across markets?