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Jean A Webb
Secretary, CFTC
3 Lafayette Center
1155 21st St. NW
Washington, DC 02581
secretary@cftc.gov

COMMENT

Dear Ms. Webb:

The CFTC has requested comment on The Governance of Self-Regulatory Organizations. As an academic, I have done considerable research on this subject that has been published in peer reviewed journals. As a consultant, I have also worked closely with commodity futures exchanges on issues with self-regulatory implications. I therefore have thought long and hard about many of the issues raised in the Commission's request, and appreciate the opportunity to comment on them.

I have some general comments on three of the issues raised by the Commission, namely Board Composition, Regulatory Structure, and Forms of Ownership.

In many respects, these issues are closely linked. For instance, in my opinion the appropriate board composition may depend crucially on the form of ownership. For-profit and not-for-profit member owned organizations are effectively mutual firms owned and controlled by intermediaries who supply services on exchanges. On some dimensions, the incentives of exchange owners are not aligned with those of customers. In particular, such exchanges may have too little incentive to police agency problems because exchange members can sometimes benefit from such problems. Many of the regulatory difficulties experienced at futures and securities exchanges (e.g., the trading scandals at CME and CBT in the late-1980s, or the current controversies regarding NYSE specialists) are of this variety.

Therefore, independent directors may be particularly useful for exchanges in which intermediaries have a considerable ownership stake, and exert considerable control. Intermediary dominated organizations—whether for-profit or not—would benefit most from a significant number of independent directors.

This said, one should not be too sanguine about the efficacy of independent directors. In all but exceptional circumstances, such directors will still depend crucially upon information provided by exchange members when making their decisions. Moreover, intermediaries (who represent a relatively concentrated interest in direct physical proximity to the exchange) will almost certainly incur lower costs to influence even independent directors than will diffuse bodies of exchange customers. These factors make even independent directors considerably susceptible to some degree of "capture" by the interests they are charged with overseeing.

The securities markets provide an interesting object lesson. Since the scandals of the 1930s, Congress and the SEC have attempted to reduce the power of intermediaries in the governance of the New York Stock Exchange (and other US securities markets) in

order to mitigate potential and real conflicts between the interests of the intermediaries and those of their customers. One of the means of doing this has been the regulation of SRO board composition. Recent controversies regarding regulation of brokers and specialists, and the compensation of the NYSE president indicate that this has not proved a panacea for agency problems.

In this regard, I would note that investor-owned, for-profit exchanges (in which intermediary ownership and control is non-existent, or at least not dominant) have less need for independent directors in order to ensure efficient exchange self-regulation of intermediary-customer conflicts. This is true for a couple of reasons. First, attempts by intermediary-agents to profit at the expense of customers through abusive trade practices reduce the profits of the for-profit exchange and its investor-owners. Consequently, the exchange's owners do not face a conflict of interest in cracking down on such misconduct, and indeed have a positive incentive to do so. Second, as I have noted in my earlier published work, there is a strong connection between ownership form and trading technology.[1] For-profit, investor-owned exchanges will almost certainly operate electronic trading platforms. Certain kinds of agency problems are easier to detect (and hence regulate) on such systems.

Ownership form also has other implications, as the Commission's questions clearly indicate. Many regulators have echoed the concern raised in the Request for Comments, namely, "[m]ight a for-profit, publicly traded SRO attempt to attract volume or increase its profits through lax self-regulation?"

I have written an academic paper that examines this concern in detail, so I will merely summarize the argument here.

The succinct answer to this question is "No." Not-for-profit form is an example of what economists call a "low power incentive system." Economists have demonstrated that low power incentives can serve as a customer protection device when the "quality" of a firm's output is not observable (either by customers, or by third parties charged with enforcing contracts between the firm and its customers). However, most of the attributes of exchange self-regulatory efforts have observable and often quantifiable impacts, especially for institutional traders (who currently predominate in US futures markets). In these circumstances, not-for-profit form is likely to have little impact on the intensity of exchange self-regulatory efforts.

Put differently, as I demonstrated in articles published in 1999 and 2000, exchanges adopted the not-for-profit form as a member protection device, not as a means of protecting customers. The movement to for-profit form, and perhaps extensive investor ownership, is not driven by exchanges' belated recognition that they could enhance profits at the expense of their customers. Instead, it is impelled by the technological revolution currently reshaping futures markets. The not-for-profit form (and mutual ownership) is adapted to open outcry. It is mal-adapted to electronic trading. The move to electronic trading is undermining the benefits of the not-for-profit form, and is driving the move to for-profit status. Indeed, as noted above, since many agency problems are harder to detect in an open outcry environment than an electronic one, with respect to regulatory and customer protection issues, the Commission would be ill

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[1] Craig Pirrong, A Theory of Financial Exchange Organization, 43 J. of Law & Econ. (2000) 437, and Craig Pirrong, Electronic Exchanges are Inevitable and Beneficial, 22 Regulation (1999).

advised to raise obstacles to conversion of exchanges to for-profit and investor ownership, as this would reduce their incentive to adopt electronic trading.

One should not conclude from this that for-profit, investor owned exchanges will self-regulate efficiently. Any exchange, be it a mutual not-for-profit or investor owned for-profit, may fail to self-regulate efficiently because it fails to internalize the benefits of doing so.[2] Other self-regulatory problems can be traced to exchange market power. In futures markets (as in securities markets) exchanges likely possess market power due to the nature of liquidity. The centripetal forces of liquidity confer advantages on incumbent exchanges, regardless of their ownership structure.[3]

Taking this altogether, ownership structure is likely to have little impact on the efficiency of exchange self-regulation except where certain trade practices in which intermediaries act contrary to the interests of their customers are concerned. In this particular are, investor owned exchanges are likely to be more aggressive self-regulators than mutual exchanges (regardless of whether the latter are for-profit or not-for-profit).

This analysis of incentive power, market power, and internalization of the benefits of self-regulatory efforts also has implications for Regulatory Structure. As my academic research makes plain, I am extremely skeptical of mandating a separation of self-regulatory activities from other aspects of exchange management, through, for instance, the creation of an independent self-regulator. This might be beneficial if the impact of self-regulatory efforts was largely unobservable, but as noted above, this is not the case. Moreover, creation of an independent self-regulatory body could actually exacerbate the problem of incomplete internalization of the benefits of self-regulatory efforts; this would actually reduce the effectiveness of self-regulation.

This is not to say that there are no benefits from the creation of an independent self-regulator. For instance, an independent self-regulator overseeing several exchanges may be able to exploit economies of scale and scope more effectively than an exchange. Such a body could offer its services at a price that reflects its putatively lower costs, and exchanges should be free to contract with it to take advantage thereof. However, this is not an argument to compel exchanges to obtain self-regulatory services from an independent third party; if these cost advantages are sufficiently large, exchanges will contract voluntarily for these services from the independent provider.

I would also like to take this opportunity to direct the Commission's attention to likely future regulatory and self-regulatory concerns. In particular, in my opinion, many of the sources of past concern (notably agency problems) are likely to be less prominent in the future (due to technological changes and related changes in organizational structure), but other issues will likely rise to the fore. In particular, as exchanges adopt more conventional business and organizational models (i.e., for-profit form, investor ownership, reduced influence of intermediaries in governance), I suspect that more traditional competition-related (read "anti-trust") issues will supplant agency concerns as the main source of regulatory and self-regulatory battles. Indeed, the events surrounding

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[2] This argument is made in detail in Stephen Craig Pirrong, The Self-Regulation of Commodity Exchanges: The Case of Market Manipulation, 38 J. of Law & Econ. (1995) 141.

[3] For a more extensive analysis of this assertion, see Craig Pirrong, Market Macrostructure, J. Law, Econ., & Org (2002).

the recent entry of Eurex and EuronextLIFFE into US markets and the litigation between the New York Mercantile Exchange and the Intercontinental Exchange are harbingers of such a development. Moreover, whereas in the past exchange pricing/fee decisions aroused little interest, in the future the pricing/fee policies of for-profit investor owned exchanges that capture high market shares in identifiable product segments are likely to be the source of considerable controversy. Indeed, it is my understanding that these issues are receiving attention in Europe, which has been somewhat in advance of the United States in both the adoption of electronic trading and the development of new business and organizational models.

Given the likelihood of such a development, the Commission should direct some effort to analyzing the nature of competition in US futures markets, the policy issues likely to arise therefrom, and the appropriate policy responses.

Craig Pirrong, PhD
Professor of Finance
Director, Global Energy Management Institute
Bauer College of Business
University of Houston
Houston, TX 77204