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Derivatives Study Center

COMMENT

August 21, 2000

Office of the Secretariat,
Commodity Futures Trading Commission,
Three Lafayette Centre
1155 21st Street, NW
Washington, D.C. 20581

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Re: Regulatory Reinvention

Dear Ms. Webb:

This letter is submitted as a comment letter on the Commodity Futures Trading Commission's ("CFTC") proposal to adopt a new framework to deregulate derivatives markets. That new framework was spelled out in a Federal Register release published on June 22 of this year.

While the CFTC's proposed deregulatory framework reflects the hard work and fresh thinking that went into its formulation, it nevertheless contains some serious flaws. These flaws are the result of incorrect assumptions or misunderstandings about how derivatives markets actually operate.

The first and most serious flaw is the reduction in measures to prevent and police against market manipulation. These measures include the elimination of requirements for large trader reporting and limits on speculative positions. This is based on upon the assumption that the markets for financial instruments such as securities, foreign exchange, and interbank loans are so large that they cannot be manipulated.

While it is true that many financial markets are very large, it is not true that size alone prevents manipulation. Consider the following recent examples.

The world's largest market is that in foreign exchange. The Quantum Fund, a hedge fund operated by George Soros, is widely credited for having had the market power to bring down the value of the British pound in the foreign exchange market in September of 1992. The IMF agreed, saying, "hedge funds at times had a strong effect on asset prices, particularly in light of the relative size of their positions in specific markets." The market for U.S. Treasury securities, with its \$600 billion in daily trading volume and another \$1 trillion in repurchase agreement transactions, is the world's premier market in terms of efficiency and sophistication. Yet this market has been the subject of manipulation several times in recent years. Salomon Brothers investment bank cornered an auction in 1992, and in 1993 the investment bank Fenchurch cornered the 10-

year note in order to squeeze the futures market. The head of the Federal Reserve Bank of New York's open market desk has warned market participants on several occasions in recent years about ongoing incidents of market manipulation in the repurchase agreement market.

The above examples pertain to instances of major market manipulation such as the Hunt brothers' manipulation of the silver market, Ferruzzi's manipulation of the soybean market, or Sumitomo's manipulation of the copper market. But public interest concerns with manipulation should not be limited to major market manipulation. The leverage provided by derivatives contracts can be used to capture substantial gains from very small or "minor" manipulations of market prices. Derivatives priced upon market opening prices – not currently the case on existing futures exchanges but a potential development under the new framework – have been subject to distorted first bids or offers.

Another and related flaw built upon the same erroneous assumption is the proposed elimination of requirements for reporting on daily trading volume, prices, and open interest. This information, together with large trader reporting data, has been used effectively by the Commodity to detect and deter manipulation as well as to head-off potential "disorder" in the markets. Some of this information is made public in order to help improve market transparency. Improving market transparency was perhaps the most clearly understood and widely accepted lesson to emerge from the collapse of Long Term Capital Management hedge fund. Yet this new framework will diminish, not improve, transparency.

Another flaw in the deregulatory framework is its lack of concern with its potential impact on the smooth, orderly functioning of derivatives markets. Deregulation will do away with requirements for price limits that have proven effective in maintaining orderly market trading. It also will potentially lead to market fragmentation when current markets are divided into sophisticated and non-sophisticated, or alternatively electronic transaction facilities and contract markets, and thereby drain away the liquidity for investors left in the smaller market.

Yet another flaw in the deregulatory framework derives from the incorrect assumption that limiting market participation to "sophisticated" investors is sufficient to assure soundness and well-functioning markets. Consider the case of an investment firm with \$5 billion in capital and a management team made up of the former head of the top bond trading firm on Wall Street and a couple of economists who received Nobel prizes for developing derivative pricing formulas. This combination of capital, financial market experience, and intellectual brilliance is at the very highest standard for market sophistication. Yet these attributes, plus \$1.4 trillion in derivatives, were the state of Long Term Capital Management. These "sophisticates" orchestrated such an enormous failure that they lost not only 90% of investors' capital, but also disrupted activity in several key financial markets in the U.S. and threatened the solvency of many of the largest financial institutions. Sophistication is clearly not enough to assure that derivatives markets do not threaten the rest of the economy.

The last flaw is built upon the failure to understand the potential monopoly power of derivatives markets. The benefits of liquidity are substantial, and therefore market participants will gravitate to where liquidity is greatest. This movement further adds to the liquidity of the most liquid market and detracts from that of the less liquid ones. This

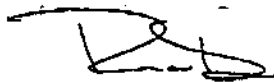
process can result in the establishment of a single marketplace. The owners or managers of such a single marketplace are not subject to pressures from market forces to address the needs of all their customers and this is especially true for their smaller customers.

In the past, the CFTC has acted as an intermediary between customers and the futures exchanges in these matters. In the process, the CFTC as an institution as well as its individual Commissioners have come under tremendous pressures. These deregulatory changes will put an end to the CFTC's role as intermediary, and yet market forces are unlikely to assure that all customers' demands will be met.

These problems with the underlying assumptions to the new deregulatory proposal should be properly addressed before continuing with the rule making process. If large markets are subject to manipulation, or if market transparency should never be diminished, or if sophistication is not enough to assure market safety and soundness, or if derivatives markets sometimes exercise monopoly power in regards to their customers, then the proposed deregulatory framework is not consistent with the CFTC's Section 4(c) exemptive authority which requires that any exemption be consistent with the public interest, purposes of the Act and not materially effect the CFTC's ability to exercise its duties.

I appreciate the opportunity to present these views and request that this letter be included in the Federal Register and your web-site as a comment letter.

Sincerely,



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