

AUTHOR'S NOTE

The De Angelis affair did, indeed, spawn legislative proposals. An invitation to appear before the pertinent subcommittee was a welcome opportunity to educate the Congress about the fundamentals of futures markets and to express faith in a competitive economic system that congressmen generally profess but deny in their approach to regulatory legislation. Did it have an effect? Who knows? But, it was a fun "in your face" game.

STATEMENT TO THE DOMESTIC MARKETING AND CONSUMER RELATIONS SUBCOMMITTEE OF THE HOUSE AGRICULTURE COMMITTEE

April 6, 1966

A proposal for the extensive amendment of the Commodity Exchange Act has been placed before both houses of Congress of the United States Department of Agriculture. If enacted into law, these changes may have major effects on the operation of existing futures markets. More important, they will have major effects on the development of futures markets for additional commodities that, as a result of the nature of the commodities, need to take on quite different characteristics than the older markets. Some of the provisions of the proposed legislation are salutary and should receive support. Others contain possibilities of causing severe damage and should be rejected.

CHAPTER 24

PHILOSOPHY OF THE PROPOSALS

An understanding of the proposals first requires a look at the philosophic concepts involved. First, the bill is massive and comprehensive. For many years, the Commodity Exchange Act has been amended in a piecemeal fashion, and the Congress has considered small suggestions for change in such a way that the law, as it now stands, has gradually evolved. The proposal for massive change implies that this procedure has been inadequate. It casts critical reflection on the legislative history of the existing law. However, the economic effectiveness of existing futures markets supports the historic process and casts doubt on the need for great changes.

Second, the proposals would invest sweeping powers in the hands of the Secretary of Agriculture. He would have great discretion in control of businesses and individuals and, indeed, over the market mechanisms. Philosophically, I suggest that economic affairs should be regulated by markets and by law. They should not be regulated by administrative fiat.

Third, the proposals are concerned with the same two major aspects of futures trading with which all of the legislation since 1921 has been concerned: (a) manipulation and excessive speculation, and (b) protection of the public from malpractice and fraud. I have no quarrel with the latter of these and will not speak of the parts of the bill that pertain to commission futures merchants, financial responsibility, etc.

The USDA has long been preoccupied with price excesses in futures markets and, thus, with manipulation and excessive speculation. The underlying concept seems to be that futures markets exist for hedging and that speculation is a necessary

evil, that hedging is good and speculation is bad, and that speculation should only be tolerated to the degree necessary to absorb the risks shifted by hedgers.

A good example of this attitude is found in some comments of the Joint Committee of the Economic Report in December 1947. Mr. Mehl, who was then administrator of the Commodity Exchange Authority, said, "I believe that if we are to maintain the present system of marketing, with the incident of hedging which enables processors and dealers to transfer the price risk from their shoulders to speculators who are willing to assume these risks, we will have to tolerate some degree of speculative trading in order to take up the slack between the merchant and processor who wants to buy for hedging purposes, and the one who wants to sell for hedging purposes." In immediate response, Representative Rich said, "I am not interested in trying in any way to stop legitimate business; I want that to proceed. But, I thought if there [were] anything that you could suggest to our Committee whereby we might, from your experience, stop speculation pure and simple, and let legitimate trade go on, I wish you would make that recommendation."

Hedging serves useful economic purposes that have long been understood and appreciated. The legislative record is replete with testimonials; the textbooks describe and extol the merits of hedging; and the Commodity Exchange Act has been changed from time to time in the direction of more considerate treatment of hedgers.

In fact, hedging is the lesser beauty of futures markets. These markets are competitive pricing institutions operating in a highly uncertain and, thus, speculative context. The futures prices established in these markets are speculative prices established by the trading activities of speculators. In addition to absorbing the risks shifted by hedgers, speculators serve the necessary and useful purpose of establishing prices that regulate the flow of stored commodities onto the market and that guide future production.

Thus, the two major functions of futures markets are risk shifting and pricing. In my judgment, the speculative pricing function is of the greater importance, and it is performed better as the level of speculative activity is greater.

Commodity prices have certain jobs to do. Most important among these are the guiding of production and the regulation of the rate of consumption. The prices that will result in an equilibrium between demand and supply forces are uncertain and, thus, speculative. Equilibrium prices continually change as the underlying factors affecting supplies and requirements change. The market is continually searching for that single price that will just equate supply and use. If the market were all knowing and all wise, there would be no price variation. As the balance of judgments in that market is that the price should go up, it is quickly bid higher. The converse is, of course, true. All things foreseen are quickly discounted into current

prices so that, at any given time, the judgment of the market is that price will not change.

These speculative functions must be performed whether in futures or in cash markets. There are futures markets for only a few of the many commodities that move in commerce. The question is whether the speculative job is accomplished better in futures markets than in cash markets. A perfect job would be no price variation. This is not possible because some things are unforeseeable, such as drought, floods, etc.

Careful examination of futures markets—comparisons of the price variation in actively speculated markets and the less actively speculated markets, and comparisons with price variation of commodities in which there are no futures markets—suggests a stabilizing influence of speculation. Most certainly, the actively speculated markets do not have any consistent pattern of price variation. Variations in prices are random.

For every long, there is a short, and, thus, for every dollar gained, there is a dollar lost. Speculation, then, is a zero-sum game in which speculators vie with each other for profits that they, in the aggregate, cannot achieve. Competition in the major futures markets is so highly developed that the theoretical model of perfect competition is closely approached. Speculators compete with each other, and each competes against the market. When a speculator takes a market position, he is saying, "I am right and the market is wrong." The thing that he thinks he is right about is that price which will just equate supply and use. And this is also what the market thinks it is right about.

The speculators who are accurate in their forecasts make money, and those who are wrong lose. In his quest for profit, the speculator is guided to making the best price forecast of which he is capable. He then hazards his money in support of his judgment. Thus, speculation is what futures markets are truly about, and speculators are very skilled. First, tremendous efforts go into price forecasting. The most advanced techniques are employed. The network of information is extensive. For example, the recent rain in South Africa was quickly registered in Chicago corn futures prices.

A second indication that futures markets are good is the difficulty that price forecasters have in being right. Over the years, I have achieved some stature and reputation as a forecaster of soybean and soybean product prices. I do not want to do anything to destroy this concept, but I have looked back and must recognize that, at best, I have batted only slightly better than five hundred. This mediocre record does not indicate that I am incompetent, but rather it is mediocre because I have been batting against major league pitching. The market is a tough competitor.

The USDA does a lot of price forecasting. The several Situation Reports such as Fats and Oils, Feed, Wheat, etc., are competently prepared and very useful. However, their record is no better than mine. When power is granted to the Secretary of Agriculture to control excessive speculation that is judged at a given time to have put prices too high or too low, someone has to decide when the existing price is too high or too low. Price excesses can be judged by hindsight, but I do not know of anyone who is qualified to make such a judgment with sufficient accuracy to dictate the market price. If there is such a person in government, he should be moved to price outlook work. I doubt that there is such a person, government salaries are not that high.

The point that I wish to emphasize is that the wisdom of the market is great. If this were not so, it would be possible for every reasonably competent technician to make a fortune. This obviously does not happen.

The burden of what I have said is that the philosophic concept, that hedging is good and speculation is a necessary evil, is wrong. Competitive speculation in major futures markets is a thing of beauty and a joy forever. Legislation with regard to futures trading must recognize this.

ANCESTRY

I should next like to speak to the ancestry of the bill. Some of the current proposals are orphans who have been looking for a father for a long time. The request for authority to control margin requirements was associated with the efforts to prevent inflation and reduce the high price of grain in December 1947. In 1948, the case for control of margin requirements was related to the severe decline in grain prices in February 1948. In 1950, the request for control over margins was attached to the Defense Production Act of 1950. None of these fathers claimed the orphan.

The alleged father of the current set of changes is Mr. Tino De Angelis of Allied Crude Vegetable Oil and sundry other companies. It is fitting that the amendments should be on a massive scale because certainly the De Angelis affair was massive. But never has a less likely parent been chosen. The single most important argument against the current bill is the tremendously successful performance of futures markets under the impact of the De Angelis assault. In early 1964, Mr. Warren Collins, of the American Farm Bureau Federation, asked me for my opinion about the proposed changes in the Commodity Exchange Act and, in the same letter, "how the soybean oil scandal developed and how it might have been prevented." I replied under the date of June 3, 1964. It is a long letter and for this I apologize, but it tells a story about futures markets that badly needs telling.

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FOUR OBJECTIONS

Finally, I would like to comment on four specific provisions of the bill. First, the abolition of the Commodity Exchange Commission. The most important function of the CEC is the establishment of speculative position limits. In 1936, the Congress reserved authority to limit positions to the commission composed of the Secretary of Agriculture, the Secretary of Commerce, and the Attorney General. This put a desirable brake on precipitous action. I cite an example. In 1953, the USDA proposed speculative limits of fifty contracts per person on soybean oil, cottonseed oil, and lard. These were amounts of about 2 percent of the open interest then existing. It was argued in opposition that such small amounts would inhibit the growth of the young soybean oil market and impair its use. The CEC adopted the amount but suspended the implementation indefinitely. The limits are in existence today but remain suspended. On March 17, 1966, the open interest in soybean oil futures at Chicago was 17,023 contracts. The 2 percent standard applied to this amount would be 340 contracts. I think that had the fifty-contract limit been put into effect, the market would not have grown and developed into the very useful hedging and pricing mechanism that it now is. An unwise action was prevented by the CEC; it should not be abolished.

Second, cease and desist orders, and injunctions. These two things would permit the Secretary of Agriculture, directly or through the Attorney General, to compel traders to comply with his notions of what price behavior should be. It presupposes that the Secretary can recognize incipient cases of price distortion. A basic criticism of these provisions goes back to the difficulty of anticipating price changes. Seemingly erroneous courses of prices often, if not usually, turn out to be quite correct when we gain the advantage of hindsight. Speculative actions that seem most misguided usually turn out to be correct and profitable.

Were such power placed in the hands of the Secretary, there would be a great temptation for him to act frequently and closely control markets. His slogan might well be: "When in doubt, prevent—because we cannot afford to have failed to take action when evidence of illegal action subsequently comes to the fore." It is difficult enough to be a speculator without being subject to precipitous action of the Secretary. The Secretary now has great powers of persuasion because he has power to bring action when violations occur. To grant the power of cease and desist and of injunction is to grant the power to punish. This does not belong to a regulatory agency but rather to the law and the courts.

Third is the definition of manipulation. The bill says that "the word manipulate shall be construed to mean the exacting, causing, or maintaining of an abnormal or artificial price by any course of action which raises, depresses, fixes, pegs, or stabilizes the price at or to be a level different than that which would otherwise pre-

vail." As I read this, it says that at any time an artificial price is judged to have existed; that is, if a price declines subsequent to a rise or rises subsequent to a decline, everyone who had a part in the move is guilty of manipulation. Everyone who makes a trade, even the smallest job-lot trader, has an effect on price and causes it to be something different that otherwise would have prevailed. Thus, every trader would be guilty and those selected by the Secretary would be punished. Accusations of manipulation have been brought by the Secretary on numerous occasions during the past thirty years. Some of the accused have been found guilty, and some have not. I do not think that the law should be changed to define all of the accused guilty.

The word *manipulate* was not defined in the Commodity Exchange Act of 1936. Definition has been left to the courts. Over the years, a fairly clear concept of the nature of manipulation has evolved. This concept contains five considerations: (1) an artificial price, (2) intent, (3) effective control of the cash supply, (4) a dominant position in futures, and (5) causation of and responsibility for the artificial price. Each of these is subject to investigation and judgment. Manipulation cases are not simple. They are not simple because the forces affecting prices and of competitive power in markets are not simple. They cannot be made simple by definition in the law.

Fourth is the control of margin requirements. As I have pointed out, this proposal has a long history, and the Congress has wisely refused its passage. The alleged purpose of the proposal is control of excessive speculation. To use margins for this purpose requires that the Secretary identify excessive speculation when it is occurring. We can only tell in retrospect whether a given price change is warranted or not.

An important reason for not granting margin control is that it would not work. Suppose that the longs do get overly exuberant, the price goes up sharply, and this is recognized by the Secretary. He imposes higher margins. The longs will not have any trouble; they already have profits and experience no difficulty. The shorts will have difficulty since they have losses; it is their capital position that is extended. An increase in margin requirements will force them to buy in short positions, lending further upward impetus to prices. Long speculators do not mind a margin call in a rising market; the shorts do. I have long been intrigued by CEA thinking on this matter.

Margin requirements serve the necessary and useful purpose of guaranteeing contracts. The exchanges keep them at levels adequate to accomplish this purpose. The De Angelis affair makes this clear. The validity of contracts is essential to the effective functioning of futures markets. This function of margins should not be endangered by giving some other purposes to margins.

Margins should be kept at minimum levels consistent with contract guarantee. Capital for carrying inventories is furnished to markets by speculators at a very low or negative rate of return. If speculators are impaired from furnishing capital, the cost of obtaining funds from other sources will be greater and the cost of markets increased. Money to finance inventories that are hedged can be obtained at prime rates. This is true because there is almost no risk of loss. There is no risk of loss to banks because speculators assume the risks of ownership.

Margins should be kept at minimum levels to maximize competition in markets. Margins affect ease of access to markets. The markets' best defense against dominance by a few, monopoly, manipulation, or overexuberant speculation is competition provided by other traders who detect and defeat such efforts and mistakes. This is the stuff that successful speculators are made of. Their ability to enter the market and compete should not be impaired.

CONCLUSIONS

The four provisions that I have singled out are not the only ones to which I object, but they are sufficient to make my basic point: the underlying philosophy of the bill is wrong. It is based on a misunderstanding of the nature of speculative markets. The bill reveals a failure on the part of the USDA to appreciate the function of commodity futures markets in providing risk capital and in the establishment of interim prices.

The bill fails to recognize the high order of competition that exists in futures markets and, in fact, denies the effectiveness of competition in market regulation. Its central thesis is that competition is not a sufficient means of price establishment and that competition is not a sufficient means of controlling market excesses, dominating power, and manipulative efforts. In essence, the bill is a denial of the effectiveness of a competitive economic system.

Legislation, with regard to futures trading, should have as its basic objective an increase in the competitiveness of the markets. The function of the law in economic matters is to establish a framework of rules within which competition can flourish and be maximized. Past this point, we must have faith in the system.

My fundamental plea is for an appreciation of futures markets as belonging to the highest order of competition and for an expression of faith in the wisdom of the market. In this piece of legislation, you are faced with a choice between the wisdom of the Secretary of Agriculture, whoever he may be, and the wisdom of the market. I think it best to choose the wisdom of the market because this wisdom is the essence of our competitive economic system.