Author's Note

A request from the staff of the Senate Committee on Agriculture and Forestry presented another opportunity to beat on the same old drum of opposing more government intervention and promoting a better understanding of the positive role of speculation. In addition, I tried to open a new door of raising questions about the performance of futures commission merchants. Numerous subsequent telephone conversations reflected much less of a witch-hunting attitude and a more sympathetic posture than I had encountered in earlier Congressional contacts.

A Comment on Review of Futures Trading Legislation

Chapter 32

Mr. James Thorton of the staff of the Senate Committee on Agriculture and Forestry asked the question (as I summarize it from our recent telephone conversation): What improvements should be made in futures trading, and what changes should be made in existing legislation to facilitate such improvements? This is not a simple question because there is much that is not known or understood about futures trading and about what makes markets succeed or fail; neither is the place of government regulation fully understood.

I am an enthusiast about the growth and development of futures trading as an institutional system for financing, inventory management, and pricing in the U.S. economic system. Trading in commodity futures is the closest approximation to a system of pure competition that exists. A competitive economic system is an ideal toward which we should strive because of the efficiencies and equities such a system affords. Competition is the key factor that has made the American economic system so tremendously effective. The institution of futures trading has long been associated with a limited number of raw agricultural commodities, the grains in particular. It has expanded to other agricultural commodities, such as hogs and cattle, and to an increasing number of nonagricultural commodities, e.g., the metals. There are studies under way to extend the system to petroleum and its products, ocean freight, and home mortgages. Recently futures markets in international monies and stock options were launched.

Existing futures markets are not very large. I cite particularly pages 287–289 of my book *Economics of Futures Trading* (a copy of which I sent to Mr. Thorton). Corn is the oldest futures market and one of the most successful, yet it is quite small. The current open interest is on the order of 325 million bushels, as compared with a crop of 5,761 million. Cattle futures have done quite well since trading was started in 1964, yet rarely does the open interest get as large as 10 percent of the cattle on feed. The economic forces that give rise to futures trading are changing in ways which will result in major growth in markets during the years ahead if markets are organized and operated in ways which facilitate growth and development.

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In looking at legislative proposals, we should take a broad view of the developmental problems. Futures markets are fragile. The long record of attempts to develop markets which have subsequently failed underscores this point. At least three major attempts to establish an effective grain sorghums market have been made. Two have failed, and the third, at the Chicago Mercantile Exchange, is disappointing. There are many more exchanges where futures trading is authorized than where there actually is trading. We do not really know what makes a futures market succeed or fail. We should, indeed, be very careful that legislative changes do not endanger existing markets, and that they do foster the growth of these markets and the development of new ones. I would like to see what a viable speculative futures market in petroleum could do to the monopolistic structure of the petroleum industry. I think it would force it to be a great deal more honest.

I am not sure the current climate is optimum for the consideration of major legislative changes. The past fifteen months have seen unprecedented turmoil in commodity prices and price relationships. These have attracted wide attention and criticism. As has always been the case, futures trading has been identified and castigated as a cause thereof. Speculation in futures markets has nearly always been blamed when prices are too high, too low, or too variable. There is now a large amount of Congressional and journalistic attention being paid to futures trading. The speculative pricing performance of markets during the past fifteen months has left a great deal to be desired. Part of the reason is that the job of price forecasting has been extremely difficult. *And part of the reason is that markets have been underspeculated.*

As you may know, I have paid close attention to the supply, demand, and price situation in the soybean complex for many years. Soybean and soybean product prices have been gyrating most wildly during the past year. On June 5, 1973, I made a note of prices in the soybean complex.

As the traffic, both in person and by telephone, has come through my office in recent months inquiring about the place of speculation in futures markets in price gyrations, I have thoroughly enjoyed pointing out that part of the problem is underspeculation. This is somewhat akin to swearing in church and then demonstrating that what I say is correct.

The crux of the matter rests on the method by which speculation is measured; this is usually done by the volume of trading. It is an error. The huge increase in the volume of trading is noted and associated with speculation. The appropriate measure of speculation is the size of positions held by speculators. One speculates by taking a position, not by trading. If I buy one contract of May 1974 corn at 11:01:05 a.m. on September 26 and sell it at 11:01:10 a.m. the same day, I have not speculated very much, nor affected prices very much, but I have contributed to the volume. If, on the other hand, I buy one contract of May 1974 corn on September 26, 1973, and sell it on April 15, 1974, I have committed my judgment and financial resources to putting the price of corn up and keeping it there. I have assumed risks and affected prices during the period when the contract remained open. It is open interest that counts.

The structure of the open interest which I cited in soybeans applies in other markets as well. On August 31, 1973, reporting speculators were long 159,200 bales of cotton and short 8,400 bales for a net long position of 150,800. Nonreporting traders were long 472,500 and short 458,200 for a net long position of 14,300. Reporting hedgers were long 1,042,600 bales and short 1,207,700. Note that the market was primarily commercial. If we assume that all nonreporting traders were speculators, the total net position of speculators was long 165,000 bales. This is not very much out of a crop of 13 million. We must look elsewhere for the cause of price gyrations in cotton and in other commodities.

Beginning with the Grain Futures Act of 1922, we have had more than fifty years of federal regulation of futures trading. Federal legislation, the Commodity Exchange Act of 1936 in particular, has been amended continually. The last major overhaul was in 1968. Looked at in total, regulation has been successful. I think that legislation and regulation have had too much of an anti-speculation bias and been too much concerned with minor variations in prices. Market self-regulation works much better than is generally thought.

Many, if not all, of the current proposals have been considered before and mostly rejected. Without going into these in detail, some reaction to a few of them may be given. First, Paul Findlay of the House is introducing a bill to include all commodities under the CEA. This started last year out of the scandals associated with options trading in nonregulated commodities—illegal in regulated commodities. It is a good addition to the law. There is no reason to regulate some commodities and not others, the arguments of the New York exchanges notwithstanding.

Second, there is a proposal to broaden the representation on the boards of directors. Steps have been taken by some exchanges. The makeup of most boards of directors is a balanced representation of the membership, ranging from commercials to locals to commission houses. Exchanges are great democratic institutions; they are quite sensitive to the interests of outside trade because that is where business stems from. I sometimes think that they are too democratic; they have great difficulty getting needed changes made. For example, the Chicago Board of Trade is underfinanced. It has been trying for some time to get a clearing fee through which would be comparable to the Chicago Mercantile Exchange's but has had limited success. Last year there were changes made in delivery terms for soybean meal futures; they were a step in the right direction but not enough. The committee making the proposal took the change just as far as they thought they could get a favorable vote from the membership. Broader memberships on the board of directors might do more harm than good.

Third, there is an attempt to make the CEA an independent agency or at least take it out of the USDA. I am not enough of a student of government to comment intelligently. Commodity futures are losing their agricultural identity but remain largely agricultural. My midwest agricultural biases tend to show when I consider a change.

Fourth, there are those who wish to give the CEA power of injunction, to let it determine that a given situation is out of line and order liquidation only, to instruct individuals and firms to liquidate, and to set price limits. This was turned down in 1968. It is dangerous. Markets deal in uncertainty. There is no way of knowing what real value is until the advantage of hindsight is gained. It exchanges the rule of competitive forces for administrative judgment. I don't know who is all that smart.

Fifth, there is again a suggestion that the CEA should have control over margin requirements. This has been brought up many times and turned down as many. The proposal makes no sense to me. I spoke to the subject fairly extensively in my book (pages 318–322). Existing margins have worked quite well during the turmoil of the past year.

Sixth, it is proposed that control of delivery points be turned over to the CEA. The Chicago Board of Trade was too slow in changing delivery terms for oats and may have let the market die. It has been too slow in changing the terms of the wheat contract. (I would be more critical if I could figure out what the wheat delivery terms should be.) I think that the soybean delivery location will need to be changed in a few years; the exchange is working on the problem. The corn delivery terms at Chicago should be adequate for quite some time.

Problems of hedgers during the past year, particularly in corn, have been attributed to delivery terms. I think this is an error. The problems have related to transportation limitations in delivering such huge amounts for export. Price relationships have been badly distorted. The same distortions would have existed had delivery locations been different. Other people would have had the delivery problems, but those difficulties would not have been any less. The transportation tie-ups are rapidly moving toward solution.

Delivery points should be held at a minimum consistent with a representative price. A multiplicity of delivery points tends to weaken the price structure which, again, offends my midwest agricultural bias. It also tends to make price differences more erratic, which works to the disadvantage of hedgers.

As I have said, we do not really know what makes markets succeed or fail. However, it is clear that delivery terms are important. There is a note on this on page 326 of my book. Delivery terms are a delicate matter and are highly technical. I would be very reluctant to turn them over to a government body. The CEA has quite a lot of power already for general rule supervision. It is a major force in the ongoing wheat delivery terms discussion.

So much for the things at hand. What urgently needs to be done is to take a long view of the growth and development of futures markets. An adequate amount of high-quality speculation is what I think is most seriously lacking. By accumulation and disbursion they help establish prices which will just equate production and use and generate a product flow into markets that helps maintain price stability at the necessary level. By forward pricing the next year's crops and future production of such perishable commodities as cattle, hogs, broilers, and eggs, they assist in determining the amount of production. They thus provide equity capital for the production and marketing system. As they perform this discounting of events-to-come well, they contribute to the efficient allocation of resources and the efficiency of the production and marketing processes; in addition, they make money. As they do it poorly, they lose money. They have a powerful incentive, and only the most competent survive. The more extensively markets are speculated, the greater are the opportunities for producers, processors, and marketing firms to operate efficiently and with minimum risk. As I have noted, the markets are really quite small in relation to the size of the jobs to be done, and one must have reservations about the quality of much of the existing speculation. A second weakness in the system is the slowness with which contract terms are adjusted to changes in marketing conditions.

The first major step toward remedying weaknesses is to increase the amount of research in the area of futures trading. During the period 1922 to 1936, the Grain Futures Administration made quite a few landmark studies which contributed toward the writing of the Commodity Exchange Act of 1936. Basic study of market operation by the CEA has been limited since World War II. Cooperative research projections into what really makes markets tick would be useful. More information needs to be generated before regulation can be effectively changed. Major research must be done in contract terms.

I think that the area of commission house behavior in getting and handling customers is one in which there may be a place for a new kind of regulation. Because they receive the revenue (commissions), futures commission merchants bear the main responsibility for finding, training, and taking care of speculators. I am not at all certain that they understand their mission or know how to proceed with it. The exchanges have taken a few steps toward commission house supervision, but this is difficult because many houses are members of more than one exchange. Guidelines for the operation of Futures Commission Merchants need to be established, as does some supervisory procedure. I think this is probably the most useful line of inquiry the Senate Committee on Agriculture and Forestry can pursue at this time.