Cornell Law Review

Volume 74
Issue 5 *July 1989*

Article 6

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Recommended Citation

Fred S. McChesney, *Current Excuses for Regulating Futures Transactions: Avoiding the E-Word* , 74 Cornell L. Rev. 902 (1989)
Available at: http://scholarship.law.cornell.edu/clr/vol74/iss5/6

CURRENT EXCUSES FOR REGULATING FUTURES TRANSACTIONS: AVOIDING THE E-WORD

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In commenting on the paper by Furbush and Poulsen concerning regulation of futures margins,[1] I emphasize that, although I view the issue of margin regulation in terms different from those of the two authors, our points of view are more similar than dissimilar. I believe they would agree with most—if not all—of my substantive points. Let me specify as well that my understanding of the rationales offered for regulation is the same as theirs; perhaps there are other reasons given for regulation of which I am unaware. But I limit myself to Furbush and Poulsen's interpretation of the arguments made in the Brady Commission report.[2]

I
EXTERNALITIES

For the most part, those who set margins reap the rewards and bear the costs of their activities. Those who set margins too high sell less; those who set them too low incur default losses. All costs thus are internalized to the trading parties. No market failure exists in the futures industry; nothing special about futures margins justifies special regulatory rules.

As Furbush and Poulsen say, since no market failure exists in the futures market itself, "the argument for raising futures margins must rest on their external effects in equity markets," that is, their effects outside the markets where futures margins are set.[3] The external effect arises because trading outcomes (*e.g.*, prices) in the futures markets affect trading in the market for equities: "The

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1 Furbush & Poulsen, *Harmonizing Margins: The Regulation of Margin Levels in Stock Index Futures Markets*, 74 CORNELL L. REV. 873 (1989).

2 Report of the Presidential Task Force on Market Mechanisms (1988). For a discussion, see Greenwald & Stein, *The Task Force Report: The Reasoning Behind the Recommendations*, J. ECON. PERSPECTIVES, vol. 2, no. 3, Summer 1988, p. 3.

3 Furbush & Poulsen, *supra* note 1, at 874.

argument for government intervention to raise the level of margins on stock index futures presumes that these margin levels have an external effect on the futures markets. The external effect occurs because index arbitrage links cash prices and futures prices."[4]

This notion of "externality" requires discussion. "Externality" is all the rage these days in discussions of the supposed need to regulate financial markets. The E-word has become the regulators' way around economists' demonstrations that markets work better than government intervention. As I and other participants in this conference have observed elsewhere:

> "Externality" is a slippery concept, one less often used to elucidate a supposed "problem" than to justify government intervention to "solve" it. The efficiency issue is not whether any third-party impact takes place—that is inevitable—but whether the appropriate marginal conditions still hold. Many externalities are solely pecuniary; they change prices but do not raise efficiency concerns as long as prices still equal marginal cost. A problem arises only when prices and costs diverge, creating a nonpecuniary (or "technological") externality.[5]

When the E-word is uttered, would-be regulators have discovered, people ordinarily opposed to regulation may be convinced that government intervention is appropriate—even when the externality is simply pecuniary or otherwise not worrisome.[6]

The externality argument made to justify regulating futures markets is problematic for just this reason. There is no non-pecuniary externality to be cured by intervention, but framing the issue in terms of externalities lends credence to an otherwise patently empty regulatory argument. The Brady Commission recoguizes that stocks, stock index futures and stock options are components of one market, not individual markets.[7] If so, how can there be any relevant external effect between parts of the same market? When General Motors lowers its price for Chevrolets, that doubtlessly reduces sales of Fords. But that effect is simply pecuniary. If that sort of externality between futures and equity markets required regulation, so would changes involving any product for which substitutes existed—and every product has substitutes. The fact that there are pecuniary externalities linking futures and equity markets is economically irrelevant.

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4 *Id.* at 886.

5 Haddock, Macey & McChesney, *Property Rights in Assets and Resistance to Tender Offers*, 73 VA. L. REV. 701, 723 (1987).

6 For an example, see Easterbrook & Fischel, *The Proper Role of a Target's Management in Responding to a Tender Offer*, 94 HARV. L. REV. 1161 (1980).

7 This point is discussed in Furbush & Poulsen, *supra* note 1, at 873 n.1 and accompanying text.

There is a second problem with the externality argument. To require regulation, it must be true that any non-pecuniary externality cannot be internalized through lower-cost private contracting.[8] Proponents of regulating futures markets have not even addressed this necessary condition for regulation. But the stock and futures exchanges are legal entities capable of contracting. Just as each sort of exchange contractually arrives at presumably optimal rules with its members, so could different exchanges contract with one another to internalize any non-pecuniary externality.

In short, the externality argument made in favor of regulation is bogus. If I claimed that the government should regulate GM's pricing or terms of financing because they affected Ford, I would be derided mercilessly. Derision is the appropriate reaction for the parallel argument that we should regulate futures margins because of their pecuniary effects on equity transactions.

II
Refutation By The Numbers

If Furbush and Poulsen can be reproached for anything, it is a lack of derision. They jump over the theoretical issue too quickly for my taste in order to get to the numbers. This is a reproach that can be made of financial economics generally, and the reasons for this tendency are not hard to fathom. With the CRSP tapes and other marvelous price data available at so little cost, and with computer software and lap-top computers making it possible to sit in an airport and run regressions, it is hardly surprising that many very good economists like to regress first and theorize later.

But I think this is a mistake, both of economics and of politics. Economically, we all know that statistical results cannot "prove" anything causally. In and of themselves they give us correlations without causations. The causal connection—*i.e.*, the thing of real value for a social scientist—comes from using accepted theory to predict certain relationships. When the numbers bear out the theoretical predictions, we have moved from mere correlation to the critical causation.[9] Producing numbers without theory means we are settling for less than economics is able to give us.

Politically, numbers without theory reduce the effectiveness of a social scientist's arguments. In response to a regulator's argument that certain bad things may happen, all the numbers can show is that the supposed effect in fact has not occurred in a particular case.

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8 Buchanan & Stubblebine, *Externality*, 29 ECONOMICA 371 (1962).

9 This point is discussed in G. SMITH, STATISTICAL REASONING 403-05, 544-48 (2d ed. 1988).

That is the essence of the Furbush-Poulsen numbers: the supposedly undesirable external effects did not manifest themselves at the time and in the place for which the two researchers have data. But this will not satisfy the typical regulator. The supposed effects could manifest themselves somewhere else, sometime later. After all, we think of the financial events of the 1980s (including those of October 1987) as rather extraordinary. And for those bent on regulating, there is always the claim that the tests may be wrong, the data mismeasured.

Regulatory arguments based on bad economics should be corrected first by good economics, not by numbers. In this case, claims that "externalities" justify regulation should first be addressed at the general level of theory. The numbers here are irrelevant because the supposed externality is irrelevant. Suppose Furbush and Poulsen had found some deleterious effect running from futures to equity markets. That would no more justify regulation than a finding that General Motors' lower prices decrease Ford's sales.

It is unfortunate that the authors, having stated the externality argument, move immediately into the numbers without asking whether the externality is one we care about. Worse, the authors next report that in fact there is a strong price linkage between the two markets, stating that "[b]ecause of the strength of the basic linkage, trading policy in each market that affects prices in that market will have external effects in the other market."[10] True, they go on to show how this price "external effect" does not entail the problems that some claim. But they have used the E-word; regulators looking for an externality to justify regulation have the ammunition they seek.

III
"HARMONIZING" IS "CARTELIZING"

Another theoretical omission from the paper is also troublesome. The regulatory solution advanced to cure the supposed (but bogus) externality is "harmonizing" margins. "Harmonizing" means that "margin levels for purchasing and holding securities should be made consistent across marketplaces."[11] In particular, margin requirements for futures and equity markets would be "made consistent."

Given that equities and futures are part of a larger, unitary fi-

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10 Furbush & Poulsen supra note 1, at 891. For another discussion of the relationship between the two markets, see Gammill & Marsh, *Trading Activity and Price Behavior in the Stock and Stock Index Futures markets in October 1987*, J. ECON. PERSPECTIVES, vol. 3, no. 2, Summer 1988, p. 25.

11 Furbush & Poulsen, *supra* note 1, at 873.

nancial market, this proposed "harmonizing" is simply cartel price fixing. Economists and lawyers alike would deplore any attempt by GM and Ford to "make consistent" their prices and financing terms. When the government itself establishes and supervises the price-fixing cartel by limiting the number of participants (as the government did or has done for years with airlines, trucks, and trains), the results are even worse, since higher cartel prices cannot elicit new entry into the industry that will force prices back down. Government price fixing cannot succeed as long as margins in some part of the industry (here, the futures market) are not regulated. The Brady Commission would solve that by giving a regulatory monopoly to the Federal Reserve Board.

I do not doubt that Furbush and Poulsen understand this. As they say, "[t]he tradeoff between price stability and price efficiency is at the core of the financial market policy debate."[12] That characterization is helpful to an economist familiar with the issues. But for one less familiar with cartelization by regulation, that statement hardly suffices to point out what is really being advocated in the Brady Commission recommendation: good old-fashioned government price-fixing.[13]

CONCLUSION

To repeat, I am sure that Furbush and Poulsen themselves understand what is and is not relevant about externalities, and why the externality invoked to justify regulating futures markets is irrelevant. But I would be more comfortable, and more optimistic about the political effects of their arguments, if the authors dealt with the externality issue in principle before trotting out the numbers. Likewise, I am sure that they recognize price fixing when they see it. But I wish they would call a spade a spade.

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12 Furbush & Poulsen, *supra* note 1, at 897. For discussion of that tradeoff in a different context, see Dewey, *Information, Entry, and Welfare: The Case for Collusion*, 69 AM. ECON. REV. 587 (1979).

13 The question why the Brady Commission advocates monopolizing regulation so as to facilitate legal price fixing goes beyond the Furbush-Poulsen article, and is discussed in Haddock, *An Economic Analysis of the Brady Report: Public Interest, Special Interest, or Rent Extraction*, 74 CORNELL L. REV. 841 (1989).