Comments before the CFTC and SEC Joint Meeting on Harmonization of Regulation

Panel Two: Exchanges, markets, clearance and settlement, and margin requirements

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September 2, 2009

The regulatory frameworks managed by the CFTC and the SEC differ substantially in their treatment of intellectual properties, and in particular, of innovative contracts, securities, and transaction services. These differences have very significant consequences for consumer welfare. They are particularly relevant now that both agencies are involved in the creation of central clearing systems for OTC derivatives. These systems must be created to address the systemic risk and associated "too big to fail" problems that have recently challenged our economy.

Intellectual properties in markets overseen by the CFTC generally are overprotected. In particular, exchanges enjoy substantial protection from competition in their contracts. The clearinghouses that clear futures contracts only clear trades arranged at the exchanges with which they are affiliated. Consequently, exchanges have monopolies in their contracts. Prohibitions against off-board trading that appear in federal law, CFTC regulations, and exchange rules support these monopolies. As a result, many futures exchanges enjoy extraordinary profits at the expense of their customers.

In principle, competing exchanges and clearinghouses could create similar contracts to compete with those traded at incumbent exchanges. However, two significant barriers to entry make effective competition essentially impossible.

First, incumbent exchanges enjoy huge advantages over new entrants because liquidity attracts liquidity. Everyone who needs to fill an order trades at the incumbent exchange because that is where all other traders are. Economists call this effect the order flow externality. Others know it simply by the phrase "liquidity attracts liquidity." It represents a classic case of market failure. The order flow externality makes effective competition among exchanges in a given contract almost impossible.

The second barrier to entry is the lack of cross-margining agreements among clearinghouses. Without such arrangements, traders who are long one contract and short a similar contract cleared at a different clearinghouse must post substantially more margin than they need to post if the same clearinghouse guaranteed both contracts. Although their combined positions may not be risky, both clearinghouses must require significant margins from the traders because neither clearinghouse has recourse to the funds on account at the other clearinghouse in the event that the traders cannot perform following a substantial price move. Brokers or other financial intermediaries who are clearing members in both clearinghouses potentially could solve this problem, but the solution would be complicated, expensive, and inperfect.

The order flow externality and the cross-margining problem make it almost impossible for new entrants to compete against established contract markets. In only two cases have new entrants managed to compete successfully against established incumbents. Both involve exceptional circumstances. In the first, German banks colluded to repatriate the German Bund futures contract from London to Frankfurt. In the second, a relatively small group of large institutional players who were very familiar with electronic energy trading (through their operations at Enron and at various other electronic energy markets) shifted much of their trading in oil futures contracts to the electronic trading system at ICE when NYMEX failed to adopt electronic trading systems in a timely manner. These two cases are rare exceptions. In general, most significant futures contract markets are not contestable.

Proponents of the status quo argue that futures exchanges compete to identify new contracts, and that exclusive ownership of their contracts allows them to invest heavily in the research, development, and marketing necessary to develop their contracts. The merit in this argument depends on how expensive are the necessary expenditures. Although some inventions require substantial R&D, most innovations in the financial markets are obvious extensions of general principles. Innovators in the securities markets generally face similar costs, but they do not enjoy similar protections from competition. Notwithstanding, they have been much more innovative than have the futures markets which have been protected from effective competition in their products.

Proponents of the status quo also argue that price discovery and investor protections work best when all trades take place in one venue. Although I am very sympathetic to this argument, I note that the growth of electronic trading systems in conjunction with effective fair access rules ensure that efficient and cost effective price discovery can easily occur across fragmented trading systems.

Finally, proponents of the status quo argue that futures contract markets compete with OTC dealers for trading volumes. Although this competition undoubtedly has limited the pricing power of the futures exchanges, it has not been particularly effective. Exchange and clearing fees in the futures markets remain very high. The very high market capitalizations of corporations operating futures markets relative those operating securities markets very clearly indicate how lucrative protections from competition are.

The organization of clearing processes in markets overseen by the SEC allows for more competition among exchange service providers.

Many years ago, the securities industry under the guidance of the SEC formed NSCC to facilitate universal clearing of securities. These facilities allow exchanges, brokers, dealers, ECNs and ATSs to compete on a relatively level playing field to provide transaction services. The competition has been intense and has led to very substantial innovations and decreases in transaction costs. This utility was relatively easy to set up because most securities transactions clear in three days or less and because security holders do not have contract liabilities following the settlements of their trades.

The industry and the SEC also organized the Options Clearing Corporation to facilitate clearing of standardized options contracts for which writers often have substantial liabilities during the periods of their contracts. The OCC clears contracts from all US options exchanges so that traders can open contract positions at one exchange and close them at any another exchange. The competition among these exchanges for order flow has also produced innovative trading systems and low transaction costs.

The creation of comprehensive central clearing systems is essential to addressing systemic risk problems. The CFTC and the SEC both must move quickly to ensure that these systems are established.

Who will own these systems and who can access them will substantially affect innovation and transaction costs in these markets. Since the financial implications are great, Congress and both Commissions have already been under substantial lobbying pressure.

As the two Commissions seek regulatory harmony on this issue, US patent law may provide some guidance. Almost two hundred years ago, Congress created patent law to protect innovators from unfair competition and ultimately to protect end-users from unfair monopoly. Although the periods of protection have varied over time and by industry, in no case have they ever been perpetual. The Commissions should ensure that neither regulations nor the order flow externality creates open-ended monopolies in clearing services. The benefits of competition are simply too great relative to the costs of creating innovative clearing technologies.