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**A Historical Perspective on the
Different Origins of U.S. Financial
Market Regulators**

Susan M. Phillips, Blu Putnam

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A Historical Perspective on the Different Origins of U.S. Financial Market Regulators¹

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Abstract

There are varying objectives and cultural differences among the major regulators of derivative markets in the U.S. This article seeks to shed some light on the sources of differing missions among the Federal Reserve Board (Fed), Securities and Exchange Commission (SEC), and the Commodity Futures Trading Commission (CFTC) by exploring their origins. While the CFTC was not created until 1974, it has its origins in the Cotton Futures Act of 1914/16, and its focus was on the integrity of markets. The SEC was created by the Securities Exchange Act of 1934 in response to the Great Depression with a focus on investor protections. After a series of banking panics in the late 1800s and early 1900s, the Federal Reserve Act of 1913 established the Fed to promote banking system stability. After the Great Depression and WWII, the Fed's objectives were broadened to include a focus on managing the economy to achieve full employment and price stability. Our perspective is that to understand

the regulatory ecosystem in the U.S., one has to appreciate the implications of the different priorities of each regulator and, critically, whether its original focus was on market integrity, investor protections, or systemic risk.

¹ Disclaimer: All examples in this article are hypothetical interpretations of situations and are used for explanation purposes only. The views in this article reflect solely those of the authors and not necessarily those of CME Group or its affiliated institutions. This paper and the information herein should not be considered investment advice or the results of actual market experience. The authors would like to thank Professor Sykes Wilford from the School of Business at The Citadel in Charleston, SC, for his assistance with this article.

² Susan M. Phillips, retired, has considerable regulatory experience, including SEC Economic Fellow, 1976-1978, CFTC Commissioner, then Chairman, 1981-1987, and Governor, Federal Reserve Board, 1991-1998.

³ Bluford H. Putnam, is a former central bank economist, who started his career at the Federal Reserve Bank of New York (1976-1977).

INTRODUCTION

The regulation of derivative markets in the U.S. focuses on protecting individual investors from fraud and criminal activity, assuring the integrity of markets and safeguarding the economy against systematic risk emanating from the financial sector. These three critical objectives are not embedded in one regulatory authority, but are instead distributed across several institutions with very different origins and priorities, based in no small way on the historical context that led to their creation. That is, to appreciate the sources of different regulatory philosophies among the major regulators of derivative markets in the U.S., one has to examine why each institution was brought into existence and how that shaped its specific regulatory style and priorities.

Toward that end, this paper first succinctly summarizes the origins, mission, and policy focus of the three major institutions regulating financial derivatives in the U.S.; namely, the Commodity Futures Trading Commission (CFTC), the Securities and Exchange Commission (SEC), and the Federal Reserve Board (Fed). We also include an analysis of how the Dodd–Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank Act) added powers and responsibilities to each of these regulatory institutions.

With the historical context as our foundation, we provide a set of observations about how their different birth stories and missions have affected the regulatory ecosystem in the U.S. Our analysis is intended to shed light on why the CFTC, SEC, and the Fed may approach apparently similar challenges with different philosophical approaches.⁴ In addition, we provide critical perspectives on such issues as transparency, self-regulatory organizations, too big to fail (TBTF), capital adequacy, and the unintended consequences of macro-prudential regulation on the effectiveness of monetary policy.

HISTORICAL BACKGROUND

CFTC

Establishment

While not created in its present form until 1974, the CFTC had its origins in the Cotton Futures Act 1914/16.⁵ The Cotton Futures Act was specifically focused on the issue of the terms and standards for the physical delivery process when a futures contract is held to maturity. The delivery process is viewed as having the potential for fraud and manipulation, which is why futures and options have long been regulated, first by exchanges, then by governments. In addition,

federal pre-emptive regulation has allowed a distinction from state gambling regulations, preventing states from attempting to regulate futures and options exchanges under local gambling laws. Since its establishment in 1974, the CFTC has been given broad authority over named commodities "...and all services, rights and interests, ... all other goods and articles except onions and motion picture box office receipts."⁶

Mission

Quoting from the CFTC's official website, "the CFTC's mission is to protect market participants and the public from fraud, manipulation, abusive practices and systemic risk related to derivatives – both futures and options – and to foster transparent, competitive and financially sound markets."⁷

Market Integrity

The actions, rules, and regulations initiated by the CFTC have a clear focus on how markets work and ensuring the integrity of the market place. Trading must be on exchanges (designated contract markets), although there have been some exceptions granted since 2001. Market professionals must be registered. Margin requirements are enforced.⁸ Capital requirements are set to assure that exchange traded contracts will be honored. There are a variety of anti-manipulation initiatives, including speculative limits, delivery oversight, and daily settlement. Large trader reports are provided to exchanges and the CFTC to assist in market regulation, but not generally publicly disclosed except in aggregated form. The role of central clearing houses is primary to how futures and options exchanges function, and the CFTC has relied in part on clearinghouse oversight as well as embraced self-regulatory organizations (SROs) such as the National Futures Association (NFA) and the exchanges themselves.

Dodd-Frank

The Dodd-Frank Act gave the CFTC more authority to supervise and regulate over-the-counter (OTC) markets in swap transactions, and also in particular, swap dealers. Among many other things, clearing

4 Kindly note that we are not covering all aspects of the three agencies' responsibilities; rather, we will focus on market regulation responsibilities

5 The Cotton Futures Act was originally passed in 1914, but it was deemed by the courts as revenue raising legislation, which constitutionally must originate in the U.S. House of Representatives. Since the 1914 version originated in the Senate, it was declared void, and the 1916 version was then passed in the proper sequence from House to Senate.

6 See 7 U.S.C. § 13-1; CEA § 9-1

7 CFTC, www.cftc.gov/About/MissionResponsibilities/index.htm

8 Margin requirements are established by CFTC regulations and delegated to exchanges with oversight by the CFTC. By law, the Fed was given powers related to margin requirements, however, it chose to delegate its role in setting margins to the CFTC and the SEC

and trade execution for standardized derivative products, including certain swap agreements, were mandated to move to exchanges or swap execution facilities and be centrally settled in clearing houses. In keeping with the CFTC's tradition of focusing on the integrity of markets, the additional powers given to the CFTC in the Dodd-Frank legislation were generally aimed at strengthening the infrastructure of derivative markets to ensure their integrity.

SEC

Establishment

The SEC was created by the Securities Exchange Act of 1934 (as a result of the stock market crash of 1929 that preceded the Great Depression) and charged with enforcing the Securities Act of 1933. The focus was aimed directly at providing stronger investor protections. In the years and decades that followed, the SEC was also given responsibility for enforcing a number of other investor protection acts passed by the U.S. Congress, including, among others, the Trust Indenture Act of 1939, the Investment Company Act of 1940, the Investment Advisers Act of 1940, and the Sarbanes–Oxley Act of 2002.

Mission

“The mission of the US Securities and Exchange Commission is to protect investors, maintain fair, orderly and efficient markets, and facilitate capital formation.”⁹

Investor protections

Major characteristics of the SEC's approach to market regulation include transparency and disclosure (e.g., financial data by firms, stock ownership by management, market transaction data, etc.). Insider trading rules play an important role to level the trading field so that insiders cannot benefit by having an informational advantage over the general public. As with the CFTC, there are requirements for the registration of securities market professionals – brokers and dealers.

Unlike the CFTC, which views exchange-traded derivative markets as focused on risk management and is neutral on the direction of markets, the SEC has specific restrictions on short selling of stocks. Remember that part of the SEC's mission is to encourage capital formation, and it has accepted the view that in certain circumstances short-selling may cause harm to the capital formation process.

As with the CFTC, the SEC has embraced reliance on SROs to implement and enforce regulations (e.g., FINRA – Financial Institutions Regulatory Authority, as well as the securities exchanges).

Dodd-Frank

The Dodd-Frank Act gave the SEC more powers related to robust record-keeping and real-time reporting regimes including audit trails. Provisions of the Act also focused on giving the SEC anti-disruptive trading initiatives and increased securities exchange oversight to be implemented as a result of the “Flash Crash” in May of 2010 and the Wall Street bailouts associated with the financial panic of 2008 and the subsequent Great Recession. In keeping with the SEC's focus on investor protections, the Act included new governance, capital and reporting requirements for individual firms. The role of the credit rating agencies in the lead-up to the 2008 financial crisis came under severe criticism and the SEC gained powers in this realm as well to better protect investors.

FED

Establishment

After a series of banking panics in the late 1800s and early 1900s, the Federal Reserve Act of 1913 established the Fed to promote banking system stability.

Mission

The Federal Reserve Act of 1913 was all about the safety and soundness of the banking and financial system (i.e., systematic risk) and created an institution with powers of lender of last resort. The dual objectives of encouraging full employment and maintaining price stability were added after the Great Depression, an episode in which, by many counts and assessments, the Fed failed to use its lender-of-last-resort powers to limit the damage from the stock market crash of 1929 and potentially to avoid the downward spiral into deflation and the Great Depression.¹⁰

Stabilizing the banking system, then managing the economy

The Fed is the central bank of the U.S.¹¹ It was founded by Congress in 1913 to provide the nation with a safer, more flexible, and more stable monetary and financial system. Over the years, its role

9 SEC, www.sec.gov/About/WhatWeDo.shtml

10 For example, see Bernanke, B. S., 1983, “Non-monetary effects of the financial crisis in the propagation of the Great Depression,” NBER Working Paper No. 1054. Also, Bernanke, B. S., 2000, *Essays on the great depression*, Princeton University Press

11 The U.S. had been without a central bank since 1836 when the charter of the U.S. Bank was allowed to expire. In 1832, Congress passed an act to extend the charter of the U.S. Bank beyond its expiration date, and President Jackson vetoed the charter extension. The role of the central bank became a major issue in the 1832 Presidential election, and when President Andrew Jackson won a second term, the issue was settled and the charter was allowed to expire.

in banking and the economy has expanded.¹² Today, the Fed's duties fall into several general areas: (1) implementing the nation's monetary policy by influencing the monetary and credit conditions in the economy in pursuit of maximum employment, stable prices, and moderate long-term rates; (2) supervising and regulating banking institutions to ensure the safety and soundness of the nation's banking and financial system to contain systemic risk that may arise in financial markets; (3) providing financial services to depository institutions, the U.S. government, and foreign official institutions, including playing a major role in operating the nation's payments system. Until the financial panic of 2008, the primary tools of the Fed included bank reserve requirements, discount window (elastic currency, lender of last resort), and open market operations (T-bills). With the advent of the financial panic of 2008 and the Great Recession, the Fed expanded its toolkit, expanding its balance sheet and engaging in transactions involving a wider range of securities and derivatives (e.g., increased direct purchases of U.S. Treasury securities and mortgage backed securities, as well as creating and lending to special purpose vehicles holding a variety of credit and derivative exposures).

Dodd-Frank

The Dodd-Frank Act gave the Fed expanded authority over the financial system. New powers included the ability to regulate compensation practices of financial institutions. The Fed was also responsible for enforcing resolution regimes for systemically important financial institutions (SIFIs) in the event they had to be wound down. There was an expanded emphasis on a much broader definition of financial firms, well beyond banks, with emphasis on governance, risk management, capital and liquidity. In effect, the Fed was empowered to address regulatory and systematic risk challenges in the "shadow banking system." The Fed also became the central regulatory institution for international coordination of financial system supervision, which includes the negotiations for reciprocal recognition of comparable institutions, such as exchanges or clearing houses, with foreign governments and regulatory bodies.

OBSERVATIONS ON THE REGULATORY CHALLENGES OF DIFFERENT MISSIONS

How do these three regulatory regimes differ? What affects their ability to work together on regulatory reform or impacts the compliance structures required of regulated financial institutions?

Our perspective is that the different historical contexts and varying focuses of regulation that were incorporated into the creation of each of the major derivative regulatory institutions has shaped their

style and approach to market supervision. That is, the CFTC's primary emphasis on market integrity, contrasts with the SEC's central focus on investor protections and the Fed's mission regarding the containment of systematic risks.

Transparency

Take transparency as an example. The SEC puts transparency on a pedestal in attempts to protect investors and level the trading playing field. Mutual funds and asset managers have to report positions quarterly, which are made available publicly by the SEC. By contrast, the CFTC has tended to preserve the confidentiality of positions. The CFTC's commitment-of-traders report gives an aggregated sense of the positioning of large groups of specific types of traders, but there is no ability to back into the positions of any one trading firm. Individual business strategies involving price hedging are kept confidential in the CFTC regulatory structure in contrast to the SEC's requirement to disclose ownership positions in public companies.

The inherent differences between risk management instruments, such as exchange-traded futures and options, compared to capital formation instruments, such as stocks and bonds, underlie the contrasting approaches of the CFTC and SEC and help explain why their philosophical approaches to transparency policies are also different. We also note that the Fed focuses on financial confidentiality, although not nearly to the degree that the transparency issue challenges the different instruments regulated by the CFTC and the SEC.

Market direction

Then, there is the embedded view on market direction. The CFTC, with a focus on risk management tools, is neutral – price protection (hedging) in both directions is actively desired and derivative markets are considered a zero sum game. The SEC has a distinct emphasis on promoting economic growth through capital formation and this is reflected in specific restrictions on short selling. The Fed also seeks to promote economic growth, which can lead to a bias in favor of equity bull markets, although the latter has been occasionally tempered by fears of systematic risk coming from "exuberant" markets.

SROs

There are also significant differences in the approach to financial oversight through the use of SROs. With the CFTC's emphasis on market integrity and SEC's focus on investor protections, both regulators have embraced SROs. By contrast, the Fed's role in the banking system and focus on systematic risk has kept its attention

¹² Federal Reserve System, www.FederalReserve.gov/AbouttheFed/Mission.htm

on individual financial institutions. We may be stretching the point here, however we believe that these differences in approaches to SROs may be more related to budgets than to mission and focus.

The Fed has a very different budget structure than either the CFTC or the SEC. While the Fed receives user fees for its financial institution supervision and bank payments system services, in a manner not dissimilar to the fees generated by the CFTC and SEC, the Fed also has a very large net income coming from its asset-liability structure. That is, the Fed has a large portfolio of interest-bearing securities funded by virtue of its powers to issue zero interest currency as well as to set the interest rates it pays on required and excess reserves. As a result, the Fed generates substantial portfolio earnings and is typically able to return a considerable portion of its net interest income to the U.S. Treasury.¹³ Thus, while the Fed sends an annual report to Congress every year, unlike the SEC and CFTC, the Fed does not need to get its budget approved, giving it considerably more independence than enjoyed by the SEC and CFTC.

Both the CFTC and the SEC examined their use of SROs after the 2008 financial crisis and passing of the Dodd-Frank Act. The SEC previously viewed SROs as partners but recently has been bringing enforcement actions against them. This raises the question of whether SROs continue to be effective if they are placed in an adversarial position with their primary regulating agency. In addition, as exchanges have gone public, the regulatory authorities have had to assess the unavoidable conflict of interest between the business side of the exchange and its traditional self-regulatory responsibilities. While these conflicts appear manageable, the need to clarify roles is critical.

Trade-offs between containing systematic risk and encouraging market liquidity and efficiency

There are inherent philosophical debates that are becoming more obvious depending on whether the focus is on systematic risk or the efficient functioning of markets. For example, the Volcker Rule, which seeks to limit proprietary trading by certain types of financial institutions, especially banks, is part of an attempt to reduce the risk of failure leading to systematic problems. The unintended side-effect, however, is to reduce the amount of risk capital and trading activity in certain markets, potentially adversely impacting market liquidity and the costs of trading and capital formation for users of the markets.

Also, the Dodd-Frank legislation appears to have made regulatory compliance tasks more complex for financial companies. The SEC and the CFTC both have an interest in the regulation of securities and related derivative products, often with different missions and objectives that are not always easily compatible.

For example, index-based contracts trade on futures exchanges, while index-linked exchange traded funds (ETFs) trade on securities exchanges, yet often utilize futures contracts to track their benchmarks. Further, the SEC and CFTC often find themselves with challenging overlapping market concerns with the Fed regarding trading in U.S. Treasury securities and on bank trading practices involving securities and futures contracts.

Capital adequacy and too big to fail (TBTF)

TBTF will be an issue as long as economies of scale exist. Moreover, different approaches to managing the systematic risks of large institutions are likely to create considerable debate, even among the various regulators. For example, to mitigate the systematic risk of the failure of one large institution spreading through the financial network, the Dodd-Frank Act mandated that many OTC swaps now be settled through a central counterparty clearing facility. By mutualizing risk, that is, putting the clearing house in between buyers and sellers, the Act reduced the risk of a domino effect from the bankruptcy of a large institution while making clearing houses more critical to the functioning of the system. This required intermediation may reduce swap participants' contract flexibility while possibly improving liquidity, especially for exiting swap contracts.

In addition, TBTF issues spillover into capital adequacy questions. The Fed has traditionally been a regulator of banks, which are leveraged lending institutions, and capital requirements are a key part of the Fed's supervision and oversight. As the Fed's jurisdiction has expanded to non-bank institutions, with containing systematic risk as the key focus, there has been a tendency to apply bank type rules to institutions that have little in common with banks, such as insurance companies. Moreover, some clearing houses are designated as systematically important institutions for certain purposes, and, thus, the Fed may weigh in on issues impacting clearing house capital requirements, and not necessarily from the same regulatory perspective as the CFTC or SEC. If the various regulatory requirements become too onerous or costly, we may see financial institutions move offshore. Internationally, we also observe that the Bank of England is moving in this direction of using heightened capital requirements for a variety of non-bank institutions in very different types of businesses.

¹³ Prior to the 2008 financial crisis and the expansion of the Fed's balance sheet through asset purchases (i.e., quantitative easing), the Fed typically returned around U.S.\$20 billion per year to the U.S. Treasury from its net earnings. In the 2012-2014 period for example, with a much larger balance sheet, the Fed provided the US Treasury with U.S.\$80 to U.S.\$90 billion dollars annually from its net earnings.

Impact of macro-prudential regulation on the effectiveness of monetary policy

Indeed, the focus on additional capital charges for the largest banks proposed by the U.S. bank regulators and risk-based capital charges (equity or debt) for Global Systemically Important Banks (GSIFI) proposed by the Basel Committee for Banking Supervision (BCBS) are designed to mitigate the challenges of systematic risk. But a reliance on capital ratios and charges by a central bank can raise new issues with regards to the unintended side-effects related to the interaction of the conduct of monetary policy aimed at managing economic risks and regulatory activities focused on macro-prudential systematic risks. We would broadly define macro-prudential regulation as using supervisory tools to control perceived financial bubbles or asset price movements that are considered by the regulator as undeserved. These types of actions can have the unintended effect of rendering traditional monetary policy considerably less effective.

For example, in the aftermath of the Great Recession of 2008-2009, the Fed, the European Central Bank (ECB), and the Bank of Japan (BoJ) all expressed concerns, to varying degrees, about the potential for deflation. Neither zero short-term interest rates nor massive asset purchases (i.e., quantitative easing or QE) had any observed ability to encourage inflation.¹⁴ One very powerful reason for the inability of extraordinary monetary policy measures to promote an increase in inflation pressures is that the link between the credit creation process and both short-term interest rate policy and the size of the central bank's balance sheet has been severed by more stringent capital controls and macro-prudential regulation.

That is, if a central bank buys the government debt of its country it may put some limited downward pressure on bond yields, as it did in the U.S. during 2012 and early 2013, but it is not clear at all if such actions impact the decision by capital-constrained financial institutions to increase lending. What seems to matter much more for the credit creation process are the expectations of financial institutions about the state of the economy and the perceived risk of extending new loans with a careful eye on capital preservation and capital ratios. On net, in the era of expanded central bank balance sheets, central banks will own a much higher percentage of their country's outstanding government debt while the private sector will own a smaller proportion. One could even see credit agencies viewing this development as a positive factor for their sovereign credit ratings, but central bank asset purchases will not have made any difference in creating inflation. Similarly, zero short-term rates have not ignited the kind of lending boom necessary to fuel inflation pressures, because banks are much more worried about their own profitability and risks. In short, at low rates, the link between central bank policies and credit expansion is very loose if almost non-existent.

We are not arguing against expanded macro-prudential regulation. What we are observing, however, is that one form of regulation designed to mitigate systematic risk may well render other policy tools used for managing the economy less effective. And, there is the plausible scenario that relying more heavily on macro-prudential regulations, such as very large mandated capital ratios, may curtail risk capital allocated to trading activities and potentially make markets used for risk management purposes less liquid and not as efficient. These types of trade-offs are often at the heart of regulatory debates, especially when the focus of the regulators differs. The Fed's focus on economic management and systematic risk, in this sense, places it in a different philosophical position compared to the CFTC's focus on market integrity and efficiency as well as with the SEC's primary emphasis on investor protections.

CONCLUDING THOUGHT ON CULTURE AND ORIGIN OF REGULATORY INSTITUTIONS AND THE NEED TO BE WARY OF UNINTENDED CONSEQUENCES

The types of unintended consequences from the multi-institutional regulatory structure in the U.S. seem bound to become more challenging as regulators seek to achieve different objectives, ranging from improving market integrity, to enhancing investor protections, to containing systematic risk. In essence, we are brought back to two important strands of market structure and regulatory theory – namely, (1) the causes of market failure and (2) the public choice theories of why any political system creates the regulatory system that it does. Each market failure, whether the banking panics of the 1800s, or the old-style delivery squeezes in futures markets, or the stock market crash of 1929 and the Great Depression, tend to give way to new legislation and new regulatory powers specific to the last crisis or market failure. Viewed in this historical light, it is not so surprising that the U.S. has one of the more complex financial regulatory systems leading to regulatory institutions approaching similar market challenges from different philosophical approaches based on their birth stories and missions.

¹⁴ Putnam, B. H., 2013, "Essential concepts necessary to consider when evaluating the efficacy of quantitative easing," *Review of Financial Economics* 22, 1-7.

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