LECTURE 10

DERIVATIVES

Reading assignment

+ Financial Policy Forum: Primer on Derivatives
+ Financial Policy Forum: Primer on Derivatives Instruments
+ Financial Policy Forum: Primer Derivatives for Journalist
+ Financial Policy Forum: Primer Structure of OTC Derivatives Markets
+ Financial Policy Forum Special Policy Report 8: Derivatives Markets: Sources of Vulnerability in U.S. Financial Markets

• Hull, Chapters 1, 31, 32
• Mishkin: Ch. 13
• Mishkin and Eakins, Chapters 23, 24
• Liaw, Thomas and Ronald Moy. 2000. *The Irwin Guide to Stocks, Bonds, Futures, and Options: A Comprehensive Guide to Wall Street's Markets*. McGraw-Hill Professional Book Group.

DERIVATIVES

A. USE, ABUSE & MISUSE: Public Interest Concerns

Topics:

fraud
manipulation
distort or tweak accounting rules and financial reports
avoid – outflank – prudential market regulations
dodge or evade taxation
systemic risk
rogue trader and other operational risks

Market Imperfections

- OTC markets are non-transparent
- Markets are subject to destructive competition due to lack of anti-fraud and manipulation authority
- There are sometimes great amounts of excess risk taking, and externalities to that risk taking, due to inadequate capital and collateral requirements.
- Exchanges are natural monopolies
- OTC markets are less efficient, dealers make too much money
- OTC markets do not have efficient clearing arrangements
- Dealers in OTC markets have more information than rest of market, and most people in economy have little information about the market

B. Regulatory Response

Commodity Exchange Act, Section 3 of Act: "The Necessity of Regulation"
This statute stated – until being amended by the deregulatory Commodity Futures Modernization Act of 2002 – the following prescient economic point.

> "'Futures' are affected with a national public interest. Such futures transactions are carried on in large volume by the public generally and by persons engaged in the business of buying and selling commodities and the products and byproducts thereof in interstate commerce. The prices involved in such transactions are generally quoted and disseminated throughout the United States and foreign countries as a basis for determining the prices to the producer and consumer of commodities and the products and by-products thereof and to facilitate the movements thereof in interstate commerce. Such transactions are utilized by shippers, dealers, millers, and others engaged in handling commodities … The transactions and prices of commodities on such boards of trade are susceptible to excessive speculation and can be manipulated, controlled, cornered or squeezed, to the detriment of the producer or the consumer and the persons handling commodities and products and byproducts thereof in interstate commerce, rendering regulation imperative for the protection of such commerce and the national public interest therein."

CEA applies to exchanges, brokers, investment advisors, commodity pool operators plus and SROs.

Focus on exchanges and brokers.

<u>Registration of market participants</u>.

Exchanges - direct regulation, oversight and self-regulation as an SRO
Outlaws contracts unless they are traded on registered exchanges.
Contracts should have an economic purpose
Contracts should not be subject to manipulation and should minimize that likelihood

Brokers
Series 7, background checks, membership in SRO

<u>Reporting for market participants</u>
Exchanges
Large trader reporting data
Commitment of traders

<u>Capital and collateral requirements</u>
Exchanges and clearing houses must be adequately capitalized
Brokers must be adequately capitalized
CPOs must be adequately capitalized

Exchanges maintain adequate margin (i.e. collateral) requirements – this pertain to both the quantity and acceptable types of collateral

Maintain segregated accounts

Orderly Market Rules

No trading ahead of customers

Time stamp orders and trading cards

Price limits

Position limits – vary by hedger or speculator status

Contract design features:

- Help prevent manipulation, some are cash settled
- Short sellers have option on delivery date and location

Large trader position reports