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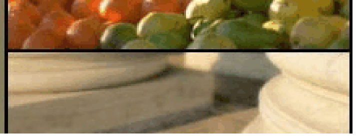

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Federal Regulation of Margin in the Commodity Futures Industry – History and Theory

by

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FEDERAL REGULATION OF MARGIN IN THE COMMODITY FUTURES INDUSTRY — HISTORY AND THEORY

*Jerry W. Markham**

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INTRODUCTION

Whether the federal government should regulate margin requirements for commodity futures contracts has been the subject of intensive debate for over fifty years. Although Congress has periodically rejected legislation that would have granted such authority, the stock market crash of 1987, and a subsequent mini-crash in 1989, have resulted in renewed demands for federal controls. The Securities and Exchange Commission ("SEC") and the Department of the Treasury contend that such controls are necessary to prevent the near disastrous set of events that occurred during those market crises.[1] The Commodity Futures Trading Commission ("CFTC") and the commodity futures industry oppose federal controls on margin, and assert that market forces, not margins, were responsible for the events that occurred during the 1987 and 1989 market breaks.[2]

1. *See* REPORT OF THE PRESIDENTIAL TASK FORCE ON MARKET MECHANISMS 1 (Jan. 8, 1988) (during stock market crash of 1987, Dow Jones Industrial Average dropped 508 points in single day; 23 percent drop was almost twice the percentage drop of 1929's Black Thursday). The financial markets approached breakdown on October 20, 1987, in part, because "the futures and stock markets were disconnected" as investors questioned the "ability of the securities markets to price securities." *Id.* at 41. The market break in October of 1989 also caused grave concern because "the nation's securities markets experienced extraordinary prior volatility, losing $190 billion in value, $160 billion in which was lost in 90 minutes." *Market Analysis of October 13 and 16, 1989,* Fed. Sec. L. Rep. (CCH) ¶ 84,706 nn.1-2 (Jan. 16, 1991). *See also SEC Chief Accuses CFTC of Distortion in Mini-Crash Probe,* Wall St. J., June 29, 1990, at C16, col. 6 (SEC chairman stated that margin controls are necessary to prevent rampant speculation in futures markets).

2. The issue of federal controls over commodity futures is intertwined with the debate over whether the SEC should be given control over financial futures products that are presently regulated by the CFTC. *See* Letter from Jeanne Archibald, Acting General Counsel, Department of the Treasury, to Dan Quayle, President of the Senate (June 5, 1990) (Congress should provide SEC with oversight authority over futures margins and authority to regulate index futures and options). *See also* Wierzynski, *Washington Update,* FIA REVIEW 21 (Jul./Aug., 1990) (congressional support for SEC Control not "deep or long"); *U.S. Treasury Plan Calls For Regulation Shift,* J. COMM., June 6, 1990, at 6A (present crisis due to failure of agencies to work together); *SEC Nominee Supports a Plan to Leave Power Over Index Futures With CFTC,* Wall St. J., Sept. 24, 1990, at A7A, col. 1, (SEC Nominee Richard Roberts expresses support for plan leaving futures regualtion with CFTC;

This article addresses these events. Part I discusses the numerous, uniformly unsuccessful efforts by the federal government to impose margin controls on commodity futures in prior years. It also describes the nature of commodity futures margins and the problems encountered in the early history of federal regulation of futures trading. Part II describes federal margin controls over securities transactions and their background. It then examines the Federal Reserve Board's view that federal margin controls are no longer serving the regulatory purposes intended when Congress adopted the controls in 1934. Part III of the article discusses the recent efforts to obtain federal regulatory controls over commodity futures margins following the stock market crash of 1987. It also examines the increased demands by the SEC and the Department of Treasury for such controls as a result of the mini-crash of 1989.

Finally, Part IV of the article examines the merits of the arguments over the need for federal margin controls. Opponents contend that rigid federal margin requirements could impair market liquidity. Proponents of margin controls contend that federal regulation is necessary to reduce market volatility and to prevent another stock market crash. The article concludes that the evidence supporting the latter view is weak. Nevertheless, there is some support for the view that residual authority could be given to the Federal Reserve Board to guard against systemic risks.[3]

I. EFFORTS TO IMPOSE FEDERAL CONTROL OVER COMMODITY FUTURES MARGINS

A. *Margin in the Commodity Futures Industry*

Commodity Futures contracts began trading on organized exchanges in Chicago in the middle of the last century.[4] Initially, these contracts took the form of "to arrive" contracts in which grain was sold on the basis of its expected

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regulation consists of "controversial stock-index futures"); Benham, *CFTC-SEC Rift Continues As Congress Readies for Recess*, Investors Daily, June 29, 1990 at 22 (plan to switch jurisdiction hotly contested in Congress); *Options Clearing Chief Backs S.E.C. Jurisdiction*, N.Y. Times, June 25, 1990, at D5, col. 5 (regulatory competitiveness hindered development of cross-margins between options and futures markets); Doggett, *CFTC's Gramm Doesn't Give Up in Index Futures Turf Battle*, Investment Dealers Digest, June 11, 1990, at 12 (high costs of jurisdictional switch outweigh benefits); Levin, *NASD Urges Members to Support Stock-Index Regulation Switch*, Investment Dealers Digest, June 11, 1990, at 9 (NASD supports exclusive jurisdiction for SEC over stock-index futures); *SEC Role in Futures Supported*, Wall St. J., May 9, 1990 at C1, col. 6 (overall market uncoordinated and subject to conflicting regulation); Sontag, *The SEC vs. the CFTC: Takeover or Stalemate?*, Nat'l L.J., Apr. 23, 1990, at 1 [hereinafter *Takeover or Stalemate*] (heart of dispute is regulation of stock index futures); *Battle Over Who Regulates Stock Futures Hearing Up*, Washington Post, Mar. 23, 1990, at C13, col. 1 (Bush administration favors SEC, House and Senate Agriculture Committees favor CFTC); *Brady Backs SEC's Bid For More Power Over Index Futures*, Wall St. J., Mar. 12, 1990, at C13, col. 3 (Treasury Dept. favors SEC control).

3. The term "systemic risks" refers to concerns that low margin requirements could result in financial failures or a liquidity crisis of such magnitude as to threaten the national economy. *See infra* notes 378-81 and accompanying text for a discussion of the Federal Reserve Board's concerns with respect to the role of margins in guarding against systemic risks.

4. G. HOFFMAN, FUTURE TRADING UPON ORGANIZED COMMODITY MARKETS IN THE UNITED STATES 28-29 (1932).

arrival date in the Chicago markets.[5] These contracts were replaced by "futures" contracts on the Chicago Board of Trade.[6] These quickly became the subject of widespread interest to speculators, as well as commercial traders.[7]

A futures contract, simply stated, imposes an obligation on the purchaser (the "long") to buy a specified amount of an identified grade or form of a commodity at an agreed upon date in the future. Conversely, the seller of this contract (the "short") is obligated to make delivery at the date specified. Because the terms of these contracts are standardized, the obligations incurred by the parties may be offset through the purchase or sale of an equal and opposite contract.[8] This permits a liquid market in these contracts and provides a mechanism for speculation,[9] because the speculator need not own the commodity or have the ability to deliver it to speculate in price changes. Futures contracts also permit the hedging of commodity prices, an important social function. As a

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5. *Id.* at 29.

6. U.S. DEPT. OF AGRICULTURE COMMODITY EXCHANGE ADMINISTRATION, A PRIMER ON TRADING IN COMMODITY FUTURES 7 (1937) (degree to which exchanges standardized futures contracts typified by wheat contracts on Chicago exchange).

7. *Id.*

8. CHICAGO BOARD OF TRADE, COMMODITY TRADING MANUAL 13 (1989) [hereinafter CBT MANUAL]. *See also* Messer v. E.F. Hutton & Co., 833 F.2d 909, 913 n.1 (11th Cir. 1987) (long and short positions defined), *amended on reh'g*, 847 F.2d 673 (11th Cir. 1988); Ryder Energy Distribution Corp. v. Merrill Lynch Commodities Inc., 748 F.2d 774, 776-77 (2d Cir. 1984) (futures contracts and role of futures commission merchants discussed); Leist v. Simplot, 638 F.2d 283, 286-88 (2d Cir. 1980), *aff'd sub nom.*, Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Curran, 456 U.S. 353, 357-60 (1982) (historical development and benefits of futures contracts described).

9. One commodity brokerage house brochure on futures trading stated that:

> For one with risk capital and the temperament to speculate, the futures market is an especially attractive medium. Margins are low (averaging 5 to 10% of the value of the commodity contract) thus giving great leverage on one's capital. Price fluctuations are frequently both wide and rapid. Thus, it is possible to make very substantial profits by speculating in futures contracts on the commodity exchanges. By the same token, it is also possible to take substantial losses.

ASSOCIATION OF COMMODITY EXCHANGE FIRMS, INC., TRADING TECHNIQUES FOR THE COMMODITY SPECULATOR 2 (1963). Speculation in futures contracts often has been likened to gambling. *See, e.g.*, 5 FEDERAL TRADE COMMISSION, REPORT ON THE GRAIN TRADE 21 (1920) [hereinafter FTC STUDY] ("speculative exchanges are available as gambling facilities and are so used"); Rainbolt, *Regulating The Grain Gambler and His Successors*, 6 HOFSTRA L. REV. 1, 4 (1977) (early attempts to ban commodity speculation). Nevertheless, in the commodity futures industry, speculation is viewed as important because it provides liquidity in the marketplace. As was stated in Congress:

> Speculation is the heart of the market and provides from 60 percent to 80 percent of the liquidity for futures transactions.
>
> Speculators help producers who want the highest price for their product and the consumers who want the lowest price for the same product. The speculator provides liquidity to the market place, and he levels the many peaks and valleys that would otherwise occur in the price structure . . . in the absence of the speculator.

120 CONG. REC. 10,626 (1974) (statement of Rep. Price).

See also United States v. Dial, 757 F.2d 163, 165 (7th Cir.), *cert. denied*, 474 U.S. 838 (1985) (speculation allows consumers to hedge against uncertainities; increases information by providing incentives to study and forecast supply and demand).

consequence, hedgers and speculators are mutually interdependent.[10] Price changes in the markets are also disseminated worldwide and form an important price discovery mechanism, another important social function.[11]

To secure the obligations of the shorts and longs, margin requirements are imposed. There are two forms of margin. The first type is the "initial" margin which generally constitutes only a small percentage of the amount of the contract that will be due upon delivery. This margin amount is often less than five percent of the total amount of the futures contract. Initial margin payments must be made by both parties to the contract and constitute a good faith deposit of money to assure performance.[12]

Initial margin requirements are set by the clearinghouse at each exchange. The clearinghouse must carefully monitor margin levels to assure that they are adequate, because it is interceded as a party to each futures contract. That is, the clearinghouse is the buyer and seller to the opposite parties of each contract. Through its intermediation, the clearinghouse makes the contracts fungible and allows their offset. In so doing, the clearinghouse becomes the guarantor of performance on each futures contract. By imposing margin requirements, the clearinghouse seeks to assure that the contracting parties will meet their obligations, so that it will never be required to fulfill its guaranty.[13] Margin require-

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10. The concept of "hedging" is the real social basis for commodity futures trading. Simply stated, hedging is a form of insurance in which commercial risks are offset in the futures markets. For example, a large institution that is managing a diversified portfolio in stocks may be concerned that the stock market will drop sharply in the next few months. The institution could sell all of its stocks and avoid that risk. Such a massive sale, however, would incur large transactional costs and present tax disadvantages. Moreover, rapid selling could reduce the value of the portfolio and disrupt the portfolio's structure and operations. To avoid these problems, the institution could, alternatively, enter into futures contracts on a stock index futures contract pursuant to which the institution agrees, ineffect, to sell a "basket" of stocks that underlie the index on which the futures contract is traded. In the event prices drop, the value of the portfolio will be diminished, but that decrease would be offset in whole or in part by profits made on the futures position.

See Katara v. D.E. Jones Commodities Inc., 835 F.2d 966, 967-68 (2d Cir. 1987) (describes use of stock index futures contracts and how they are margined); Cargill Inc. v. Hardin, 452 F.2d 1154, 1158 (8th Cir. 1971) (insurance function of hedging requires speculators), *cert. denied*, 406 U.S. 932 (1972); United States v. Grady, 225 F.2d 410, 415 (7th Cir.) (hedgers, capitalists, and gamblers distinguished), *cert. denied*, 350 U.S. 896 (1955); 120 Cong. Rec. 10,736 (1974) (statement of Rep. Poage) (speculators provide market liquidity for hedgers); 120 CONG. REC. 10,739 (1974) (statement of Rep. Mayne) (speculator assumes risk that hedger seeks to avoid); H.R. REP. NO. 975, 93d Cong., 2d Sess. 133-34 (1974) (heding relates to those who handle physical commodity in their business); CBT MANUAL, *supra* note 8, at 15 (hedging requires speculators).

11. *See* H.R. REP. NO. 975, *supra* note 10, at 132 (publicly known, uniform value for commodity created).

12. The amount of initial margin in commodities futures is often five to ten percent of the value of the commodity that is subject to delivery under the contract, as opposed to fifty percent for most securities transactions. *See* T. HIERONYMUS, ECONOMICS OF FUTURES TRADING 65 (2d ed. 1977) (although generally five to ten percent, margins are function of value of commodity represented by contract and price volatility); COMMODITY FUTURES TRADING COMMISSION, INTERGOVERNMENTAL STUDY ON SILVER, CASH AND FUTURES MARKETS 9 n.3 (1980); FUTURES INDUSTRY ASSOCIATION, AN INTRODUCTION TO THE FUTURES MARKETS 8 (1982).

13. *See* Peltz v. SHB Commodities, Inc., 2 Comm. Fut. L. Rep. (CCH) 24,810 at 36,836-37 (S.D.N.Y. 1990) (citations omitted).

ments set by the clearinghouse must be met in the first instance by the clearing members of the exchange, and they in turn impose margin requirements on their customers.[14]

The second form of margin is the "variation" or "maintenance" margin, which is based on market fluctuations. Each day, each trader's position is "marked-to-market" so that the clearinghouse may determine the gain or loss of the opposing parties during the trading day as a result of market price fluctuations.[15] A party suffering a loss on a contract (because of decreased prices in the case of a long trader or increased prices in the case of a short trader) must post an additional amount of money that is equivalent to the amount of the loss sustained. This is the variation margin.[16] It is thought that the requirement that

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> 'Clearing' is a term of art with a special meaning in the commodity futures contract market .... Every commodity futures exchange has an affiliated 'Clearing House' which stands behind every trade, thus ensuring performance of the contract and facilitating liquidity in the market place .... Every trade that is executed must be accepted for clearance by a member of the Clearing House. When a trade is cleared, the Clearing House substitutes itself for the immediate parties to the contract .... This way, every trade is cleared, so the party on the other side of the trade ... is assured of performance of the contract. Thus, 'the honoring of contractual obligations is not dependent upon the actions or solvency of any single trader.'

Id.

See also Letter from Andrea M. Corcoran, Director, CFTC Division of Trading and Markets to Roger A. Hood, Assistant General Counsel, Federal Deposit Insurance Corporation (June 5, 1985).

14. A clearing member is an exchange member that is recognized by the clearinghouse as a financially stable firm that may submit trades to the clearinghouse for its intercession. *Peltz*, 2 Comm. Fut. L. Rep. (CCH) 24,810; *SEC/CFTC Jurisdictional Issues and Oversight (Part 1): Hearings Before the Subcomm. on Telecommunications, Consumer Protection, and Finance and the Subcomm. on Oversight and Investigations of The Senate Comm. on Energy and Commerce on H.R. 5447, and H.R. 5515 and H.R. 6156*, 97th Cong., 2d Sess. 514-25 (1982) [hereinafter *SEC/CFTC Jurisdictional Issues*] (report, "Customer Protection Pursuant to Commodity Exchange Act, as Amended," of Mahlon Frankhauser, outside counsel to Chicago Bd. of Trade) (clearinghouse functions and duties defined; clearinghouse/customer margins distinguished).

15. *See* CBT MANUAL, *supra* note 8, at 68 (describes marking-to-market process). As was stated in one congressional report:

> Money paid on position losses is paid into the exchange clearing association which transfers such amounts to accounts which gained during the trading day. This daily accounting which includes the determination of contract settlement prices and margin adjustments to reflect gains and losses is called 'marking-to-market.'

S. REP. NO. 144, 97th Cong., 1st Sess. 156-57 (1981). *See generally* H.R. REP. NO. 975, *supra* note 10, at 147-48 (1974) (original and variation margins explained); S. REP. NO. 850, 95th Cong., 2d Sess. 130 (1978) (CFTC Glossary of Trade Terms definitions for "margin" and "margin call").

16. *See generally* BACHE & CO. INC., UNDERSTANDING THE COMMODITY FUTURES MARKETS 12-13 (1970) (discusses variation margin). A CFTC staff number noted that:

> Once a position in a futures contract is established, the value of that position fluctuates as the price of the underlying commodity rises or falls. Additional margin payments, called maintenance margin, reflect this movement. If a trader's position becomes less valuable and the amount of margin on deposit with the FCM falls below a 'maintenance level' the FCM makes a maintenance margin call on the customer to restore the margin in its account to the initial level. If, however, the value of the customer's position increases, the FCM owes the customer a maintenance margin (which would be credited to the customer's account unless the customer wishes to withdraw it).

variation margins be posted daily forces traders to realize their losses promptly.[17] The failure to post variation margins will signal credit problems that a trader might be having as the result of trading losses, thereby allowing the clearinghouse to liquidate accounts before the loss becomes too large.[18] To make this system even more effective, the clearinghouse requires traders to post margin funds promptly. Margin calls may be made on an overnight basis, but there may also be intra-day calls.[19] This may amount to a requirement that billions of dollars be posted almost immediately, as occurred during the stock market crash of 1987.[20]

Although brokerage firms that are clearing members have the obligation of meeting margin requirements for positions carried in their names, the rules of commodity futures exchanges require public customers—that is, buyers and sellers of futures contracts who are not exchange members—to post margins with their brokers.[21] In addition, brokerage firms may impose higher margin requirements on customers than those imposed by the exchange. This is because the

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Letter from Andrea M. Corcoran, Director, CFTC Division of Trading and Markets, to Robert Mialovich, Assistant Director, Division of Bank Supervision, Federal Deposit Insurance Corporation, (July 3, 1984) [hereinafter Mialovich Letter]. *See also* S. REP. NO. 144, *supra* note 15, at 156 (traders entitled to withdraw gains but may be required to deposit additional funds to cover losses).

17. *See Review of the Commodity Exchange Act and Discussion of Possible Changes: Hearings Before the House Comm. on Agriculture*, 93d Cong., 1st Sess. 192 (1973) (statement of Leo Melamed, Sec'y of the Bd., Chicago Mercantile Exchange).

> This unique feature is a primary factor which enables commodity markets to boast an incredibly good record in the area of insolvencies. Every firm must be monetarily 'even' with the commodity prices of the previous day. If a firm's net commitment shows a net loss on the basis of the previous settlement prices, it pays the resultant amount to the exchange clearinghouse. If a firm's net commitment shows a profit, it collects the resultant amount from the clearinghouse. This process is a daily procedure.

Id.

18. *See* FTC STUDY, *supra* note 9, at 229-30 (margins designed to protect against future losses; those who have already incurred losses assumed to be less likely to be able to cover future losses). *See also* B. CARROLL, FINANCIAL FUTURES TRADING 30 (1989).

> In a highly geared market where volatility can quickly erode the value of futures positions, the daily management of the margin system by the clearing house insures that all losses are paid up daily or the positions are closed out. The margin system provides the continual financial security which promotes contract integrity and increases the willingness of buyers and sellers to participate in futures trading.

Id.

19. Exchange rules state that margin demands must be met within a reasonable period. These rules also state that a period as short as one hour may be reasonable. Mialovich Letter, *supra* note 16, at 4 n.6. *See also* FTC STUDY, *supra* note 9, at 160 (Commission house often "stand[s] in the gap" when customer cannot be reached for margin call). The clearinghouse also monitors market volatility to determine if additional margin is needed. *See* CBT MANUAL, *supra* note 8, at 68 (exchange's computerized risk-analysis program evaluates exposure of traders in setting margin requirements).

20. On October 16, 1987, almost $1 billion in commodity margin calls were made, and over $11 billion in margin calls were issued over the next four trading days. SEC DIVISION OF MARKET REGULATION, THE OCTOBER 1987 MARKET BREAK 5-12 to 5-13 (1988) [hereinafter OCTOBER 1987 MARKET BREAK].

21. CFTC Interpretative Letter No. 84-14 [1984-86 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶22,311 at 29,528 n.6 (July 3, 1984).

brokerage firm will remain liable for the amount of the money due and owing on the contract in the event of a customer default.[22]

The following is an illustration of how the margining process may work. A customer that enters into a 5000 ounce silver futures contract on the Commodity Exchange Inc. ("Comex") would be required to post initial margin of perhaps five percent of the current value of the contract. Assuming that silver is trading at five dollars per ounce, this would mean five percent of five thousand ounces times five dollars per ounce, or $1,250. A short trader would be required to post a similar amount of initial margin with its broker. Assuming that the price of silver decreased to four dollars on the next trading day, the long trader would have to post an additional amount of $5,000 to reflect the one dollar per ounce loss in value. Conversely, the short would be paid an equal amount of money into its account to reflect the profit therefrom.

This method of margining is designed to assure performance on the contract. Except on rare occasions, margin requirements have not been used by the commodity exchanges as a means to dampen speculation or to control market volatility.[23] To the contrary, lowered margin rates are often used to induce speculators to come into markets that are illiquid.[24] Nevertheless, margin plays an essential role in assuring the financial integrity of the commodity futures process. In fact, its critical nature can hardly be overstated. There is no Securities Investors' Protection Corporation ("SIPC") or Federal Deposit Insurance Corporation in the commodity futures industry. Rather, the financial integrity of the entire commodity futures system turns on the margin process.[25]

B. Early History of Futures Margins and the FTC Study

The use of margin for commodity futures markets has a long history. The Chicago Board of Trade adopted a rule that provided for margins as early as 1865.[26] In fact, this was the first rule adopted by that exchange for futures contracts.[27] Further, by at least 1877, the Kansas City Board of Trade provided for ten percent margins. This rule had its origin in contracts for cash grain but was also applied to futures trading.[28]

Initially, exchange members could themselves decide whether to require

22. *See* T. HIERONYMUS, *supra* note 12, at 64-65 (the requirement that brokerage firms collect margin from customer assures the solvency of the former).

23. *See infra* notes 84-89 and accompanying text for a description of the exchanges' reluctance to use margin to control price volatility.

24. *See infra* notes 90-95 and accompanying text for a description of the use of lowered margin rates to increase business, despite government opposition.

25. *See infra* notes 504-11 and accompanying text for a discussion of why there is no SIPC in the futures industry.

26. 1 C. TAYLOR, HISTORY OF THE BOARD OF TRADE OF THE CITY OF CHICAGO 325, 331 (1917).

27. H. IRWIN, EVOLUTION OF FUTURES TRADING 80 (1954).

28. *Margin Requirements on Commodity Exchanges, Hearings Before the Senate Comm. on Agriculture and Forestry on S.1881*, 80th Cong., 2d Sess. 99-100 (1948) [hereinafter *1948 Hearings*] (statement of Walter Scott, Executive Vice President, Bd. of Trade, Kansas City, MO.). Cash grain transactions are simply purchases and sales of the actual grain.

margins.[29] With the development of clearinghouses around the turn of the century, however, many exchanges imposed manadatory margin requirements on clearing members.[30] For example, as early as 1919, the Chicago Mercantile Exchange mandated that margins be adjusted to the market price each day, and it required its members to collect margins from their *customers*.[31] Nevertheless, many exchanges did not establish mandatory margin requirements for commodity futures customers until the government intervened several years later and pressured the exchanges to impose such requirements.[32]

The margining of commodity futures contracts appears to have first received federal regulatory attention following widespread speculation that was triggered by World War I and as the result of a massive study of the grain trade (the "FTC Study") by the Federal Trade Commission ("FTC"). The FTC focused on the nature and role of margin for commodity futures contracts.[33] The FTC Study found that the purchase of a futures contract is similar, in its credit foundation, to the purchase of stocks on margin.[34] But delivery on a futures contract comes at a later date than the transaction itself. In contrast, stocks purchased on margin are delivered almost immediately. The study noted that "[i]n this important respect the purchase and sale of futures is a freer form of speculative activity than the purchase and sale of stocks."[35] That is, the volume of futures trading is not "restricted by the necessity of either selling only what one owns or borrowing for delivery what one sells without owning it," as in the case of stocks.[36]

The FTC Study concluded that margin on futures contracts was "both a commercial credit device and a deposit made to secure . . . against loss because of non-performance. . . ."[37] Such payments "are not part payments toward the purchase price but are merely deposits made to secure the rights of each of the contracting or interested parties."[38] Margin is used simply "to bind the bargain."[39]

The FTC Study pointed out that low margin levels for futures contracts had invited sharp market reactions when thinly capitalized traders were liquidated after a market downturn.[40] This was because small traders tended to become

29. *Id.* at 100.

30. A STUDY BY THE STAFF OF THE BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM, A REVIEW AND EVALUATION OF FEDERAL MARGIN REGULATIONS 55 (Dec. 1984) [hereinafter RESERVE BOARD STUDY].

31. *Id.* at 56. *See also* H. IRWIN, *supra* note 27, at 40-41 (margins adjusted daily; penalties provided for default).

32. *See* RESERVE BOARD STUDY, *supra* note 30, at 56 (1934 National Industrial Recovery Act Code of Fair Competition for Grain Exchanges included compulsory margin requirements).

33. *See* FTC STUDY, *supra* note 9, at 155-67 (mechanics and functions of types of margins).

34. *Id.* at 155.

35. *Id.* at 156.

36. *Id.*

37. *Id.* at 20.

38. *Id.* at 17.

39. *Id.* at 156.

40. The reference to sharp market reaction is a reference to the precipitous drop in market

overextended because they were allowed excess market exposure.[41] Initial margins allowed "pyramiding" where "paper profits" were used as margin for additional contracts.[42] Thus, traders with limited funds could use margin to increase the amount of their trading beyond their ability to pay off their obligations in the event of a market reverse.[43] Just as on a stock exchange, it is "here that the trouble arises when the market reacts."[44] "The exhaustion of margins when the [market] movement reverses itself, and the selling out of insufficiently margined accounts explains the sharpness of the [market] reaction when it comes."[45]

C. *The Failure of Early Legislation to Impose Federal Regulation over Commodity Futures Margins*

In 1922, federal regulation was imposed on commodity futures trading for the first time through the Grain Futures Act (the "Act").[46] This legislation required futures contracts to be traded on federally designated "contract markets," and it sought to prevent manipulation by requiring large traders to submit reports on their transactions.[47] Notwithstanding the FTC Study, however, the Act did not address margin requirements.[48] In fact, it was not until 1933, after a collapse in grain prices, that the federal government affirmatively involved itself in this issue. At that time, the Secretary of Agriculture called a conference of the commodity exchanges to consider what means should be taken to dampen price fluctuations. The exchanges agreed that they would adopt minimum margin requirements for customers.[49]

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prices that occurs when a large number of traders liquidate their positions. This places strong selling pressure in the market, causing prices to fall. *Id.* at 157.

41. This market exposure took the form of allowing small traders to take positions larger than what their formal resources would support in the event of a market downturn.

42. FTC STUDY, *supra* note 9, at 157.

43. *Id.*

44. *Id.*

45. *Id.*

46. Grain Futures Act, ch. 369, 42 Stat. 998 (1922) (substituted by Commodity Exchange Act, Pub. L. No. 74-675, ch 545, § 5, 49 Stat. 1491 (1936), current version codified at 7 U.S.C. §§ 1-26 (1988)). A year earlier, the Supreme Court had declared a similar statute, the Futures Trading Act of 1921, unconstitutional as an invalid exercise of congressional taxing powers. Hill v. Wallace, 259 U.S. 44, 66-67 (1922). The legislation could not be sustained under the Commerce Clause because it was not confined to interstate commerce. *Id.* at 68-69. The Grain Futures Act, on the other hand, although nearly identical to the Futures Trading Act, was founded on the authority of the Congress to regulate commerce. The Supreme Court upheld the Grain Futures Act as a valid application of congressional power under the Commerce Clause. Chicago Bd. of Trade v. Olsen, 262 U.S. 1 (1923).

47. Grain Futures Act, §§ 4-5.

48. Industry spokesmen acknowledged that there had been objections to margin trading, but maintained that margin trading was simply an initial deposit "for the mere purpose of securing the other party against a possible breach of contract." *Future Trading: Hearings Before the House Comm. on Agriculture* Pt. 6, 66th Cong., 3d Sess. 674 (1921) (statement of J.P. Griffin, President, Board of Trade of Chicago, Ill.). They also acknowledged that margin trading constituted trading on credit, but concluded that no legislator would sponsor a law to prohibit trading on credit because most of the world's trade was done on credit. *Id. See also id.* at 929 (discussion of Federal Trade Commission Report on margin in grain industry).

49. *See, e.g.*, *1948 Hearings*, *supra* note 28, at 100 (Kansas City Board of Trade required mini-

Thereafter, in March of 1934, pursuant to the National Industrial Recovery Act ("NIRA"),[50] the Code of Fair Competition for Grain Exchanges was adopted by most of the grain exchanges. The code included compulsory margin requirements of ten percent.[51] Although the code, as part of the NIRA, was invalidated by the Supreme Court in 1935,[52] most of the commodity exchanges continue to require a minimum margin from customers.[53] As a consequence, the basic margin system for commodity futures was in place by the middle of the 1930's.[54]

The Great Depression had further stimulated federal interest in regulating margin requirements in commodity futures and securities trading. President Roosevelt believed that "unregulated speculation in *securities and in commodities* was one of the most important contributing factors in the artificial and unwarranted 'boom' which had so much to do with the terrible conditions of the years following 1929."[55] The President listed speculation on margin as one of the principal abuses that needed to be regulated.[56] He stated that legislation with "teeth" was needed, and this included margins set at a high enough level so

mum 10% margin; margin escalated up to 20% as size of positions increased). The margin system for futures contracts has not changed substantially since the 1930s, except to allow Treasury Bills and letters of credit to be used as initial margin. RESERVE BOARD STUDY, *supra* note 30, at 56.

50. National Industrial Recovery Act, ch. 90, § 3, 48 Stat. 195, 196 (1934) (declared unconstitutional 1935).

51. HOUSE COMM. ON AGRICULTURE, AMEND GRAIN FUTURES ACT, H. R. REP. NO. 1522, pt. 2, 73d Cong., 2d Sess. 15 (1934). *See also* RESERVE BOARD STUDY, *supra* note 30, at 56 (history of margin requirements). A government witness stated that:

> So far as the 25 percent marginal requirement of large traders is concerned, I do not believe it can be enforced. I would like to see it enforced, and we are going to do everything we can to enforce it, and to make the code a success.
>
> Now, on the question of margins, I personally feel that the grain and commodity markets offer different problems in the matter of margins than we find in the stock market. A commodities market is handled in a different way. If large-scale speculative trading is detrimental to the market - and there is no doubt about it . . . - it would seem desirable to provide some means of restricting it. If there is to be a limit, it should be fixed in advance and not changed in the middle of the game, and made the same for all traders. While an increase of margins on large trades, as required under the code, may serve to restrict some speculative operations, it will result in even greater advantage to the trader having sufficient funds to meet such increased margins.

Regulation of Grain Exchanges: Hearings Before the House Comm. on Agriculture on H.R. 8829, 73d Cong., 2d Sess. 280 (1934) [hereinafter *Regulation of Grain Exchanges*] (statement of Dr. Duvel, Chief, Grain Futures Admin., Dept. of Agriculture).

52. A.L.A. Schechter Poultry Corp. v. United States, 295 U.S. 495, 550 (1935) (National Industrial Recovery Act unconstitutionally exceeds power of Congress to regulate interstate commerce).

53. RESERVE BOARD STUDY, *supra* note 30, at 56. For example, the Kansas City Board of Trade adopted a mandatory margin rule in 1935. *1948 Hearings*, *supra* note 28, at 100-01.

54. RESERVE BOARD STUDY, *supra* note 30, at 56.

55. HOUSE COMM. ON AGRICULTURE, COMMODITY EXCHANGE ACT, H.R. REP. NO. 421, 74th Cong., 1st Sess. 2 (1935) (quoting letter from Pres. Roosevelt to Chairman, House Comm. on Interstate and Foreign Commerce (Mar. 26, 1934)) (emphasis supplied).

56. SENATE COMM. ON BANKING AND CURRENCY, FEDERAL SECURITIES EXCHANGE ACT OF 1934, S. REP. NO. 792, 73d Cong., 2d Sess. 2 (1934) (quoting Pres. Roosevelt's message to Congress (Feb. 9, 1934)).

that speculation "will of necessity be drastically curtailed."[57] A quirk in congressional committee jurisdiction, however, resulted in a bifurcation of securities and commodity futures regulation. Commodity futures regulation, unlike securities legislation, fell under the jurisdiction of the congressional agricultural committees.[58] The committees handling the securities legislation quickly focused on low levels of margin as being a principal culprit in the unbridled securities speculation that led to the Great Crash of 1929.[59] The agricultural committees, however, paid scant attention to margin requirements because the Department of Agriculture (the "Department") opposed the industry view that speculation in commodity futures should be controlled by federal margin requirements. The Department preferred other measures, such as limiting the number of futures contracts that could be held by a speculator at any one time.[60] A Department witness testified that, based on past experience, "it is more desirable to . . . leave to the commission houses themselves the matter of fixing the amount of the margins required from various classes of customers."[61] The government believed that excessive speculation could be better controlled by limiting the

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57. *Id.* (quoting letter from Pres. Roosevelt to Sen. Fletcher (Mar. 26, 1934)).

58. *Compare Stock Exchange Regulation: Hearings on H.R. 7852 and H.R. 8720 Before the House Comm. on Interstate and Foreign Commerce*, 73d Cong., 2d Sess. (1934) [hereinafter *Stock Exchange Regulation*] (proposed legislation for securities exchange registration and regulation) and SENATE COMM. ON BANKING AND CURRENCY, STOCK EXCHANGE PRACTICES, S. REP. NO. 1455, 73d Cong., 2d Sess. (1934) [hereinafter STOCK EXCHANGE PRACTICES], (resolution to investigate stock exchange and banking practices relating to securities) *with To Amend the Grain Futures Act: Hearings Before the Senate Comm. on Agriculture and Forestry on H.R. 6772*, 74th Cong., 2d Sess. (1936) (proposed legislation to improve interstate commerce by regulating commodity futures transactions) and *Regulation of Commodity Exchanges: Hearing Before the House Comm. on Agriculture on H.R. 3009 (Commodity Exchange Act)*, 74th Cong. 1st Sess. (1935) [hereinafter *Regulation of Commodity Exchanges*] (proposed legislation to improve interstate commerce by regulating commodity futures transactions).

59. *See infra* notes 292-330 and accompanying text for a discussion of congressional consideration of the effects of low margin requirements on securities speculation.

60. The grain trade actually urged Congress to use margin requirements as a substitute for position limits. R. KAUFMAN, LEGISLATIVE HISTORY OF THE COMMODITY EXCHANGE ACT 33 (Nov. 1964). The Department of Agriculture, however, opposed that position. A representative of that Department stated:

> [W]e believe, based on our past experience, that so far as the commodities are concerned, it is more desirable to provide for the protection of margin money, and leave to the commission houses themsleves the matter of fixing the amount of margins required for various classes of customers. . . . Our aim is to protect the customers' margin money and thereby protect the market as a whole. Moreover, excessive speculation in this field is controlled by limitation rather than by higher margins which are not so readily applicable to commodities as to stocks. While an increase of margins on large trades . . . may serve to restrict some speculator operations, it will result in even greater advantage for the trader having sufficient funds to meet such increased margins.

Regulation of Grain Exchanges, supra note 51, at 29 (Statement of Dr. Duvel, Chief, Grain Futures Admin., Dept. of Agric.)

61. *Regulation of Grain Exchanges, supra* note 51, at 29 (statement of Dr. Duvel, Chief, Grain Futures Admin., Dept. of Agriculture). The government did seek protection for customer margin moneys. It wanted such funds to be treated as trust funds and to be held in special segregated accounts separate from brokerage firm obligations subject to the general creditors of the firms. *Id.* *See also* 7 U.S.C. § 6d (1988) (duties of brokers regarding monies and securities of customers).

number of futures transactions by speculators "rather than by higher margins which are not so readily applicable to commodities as to stocks."[62] Congress agreed and concluded that the most effective method for curbing excess speculation would be to limit the volume and number of contracts that could be traded by speculators.[63] Thus, Congress enacted the Commodity Exchange Act of 1936 ("Commodity Act" or "Act"),[64] which authorizes the government to establish trading limits for speculators who are not hedging against some commercial risk. The Commodity Act also grants the government the authority to define what commercial risks constitute hedging transactions that will not be subject to these limits.[65] The Act, however, does not attempt to regulate the amount of margin required for trading.

D. Margin as an Important Regulatory Tool

The Commodity Act provided for the creation of an agency in the Department of Agriculture to conduct day-to-day administration of the Act.[66] This agency, the Commodity Exchange Authority ("CEA")[67] soon reversed the position expressed by the government in the Commodity Exchange Act hearings. Early in its existence, the CEA asserted that the imposition of minimum margin requirements would "insure fair competition between commission firms and would tend to protect customers who, in the absence of substantial margin requirements, might be inclined to take a larger position in the market than their means would justify."[68] The CEA believed that increased margins could keep

62. *Regulation of Grain Exchanges, supra* note 51, at 29 (statement of Dr. Duvel, Chief, Grain Futures Admin, Dept. of Agriculture). *See also Regulation of Commodity Exchanges, supra* note 58, at 100 (statement of Dr. Duvel, Chief, Grain Futures Admin., Dept. of Agriculture) (same statement to House Comm. of Agriculture).

63. 7 U.S.C. § 6a (1988).

64. Commodity Exchange Act, Pub. L. No. 74-675, ch. 545, § 5, 49 Stat. 1491 (1936) (current version codified at 7 U.S.C. §§ 1-26 (1988)).

65. 7 U.S.C. § 6a. The trading limits simply restrict the number of futures contracts that a speculator can hold at any one time. The Act, as noted, exempts hedgers from this requirement. *Id.* § 6a. The CFTC definition of hedging that meets this exemption identifies types of commercial risks that would constitute "bona fide" hedging. *See* Commodity Futures Trading Comm., 17 C.F.R. 1.3(z) (1990) (above all, hedging transactions must be for purpose of offsetting price risks and must be established and liquidated in orderly manner).

66. 7 U.S.C. § 2 (Commodity Exchange Commission composed of Secretaries of Agriculture and Commerce and Attorney General give overall authority). The Department of Agriculture, however, was given day-to-day regulatory responsibility. *Id.* The Commodity Exchange Act regulated only a specified list of commodities, a list that has expanded over the years. H.R. REP. NO. 975, 93d Cong., 2d Sess. 34-35 (1974) (Commodity Exchange Act's authority applied to specified list of commodities which expanded over time). Today nearly all commodities are covered by the Act. *See generally* 7 U.S.C. § 2 (broadly defining commodities).

67. 7 U.S.C. § 2. Initially, the CEA was called the Commodity Exchange Administration. *See* COMMODITY EXCHANGE ADMINISTRATION, U.S. DEP'T OF AGRICULTURE, REPORT OF THE CHIEF OF THE COMMODITY EXCHANGE ADMINISTRATION (1937).

68. COMMODITY EXCHANGE ADMINISTRATION, U.S. DEP'T OF AGRICULTURE, REPORT OF THE CHIEF OF THE COMMODITY EXCHANGE ADMINISTRATION 15 (1938). Earlier, on October 9, 1936, an economist at the Department of Agriculture had suggested progressively higher margins on large positions. He stated that "margin control would tend to restrict speculation" but that "there is

"irresponsible traders and undesirable speculative forces" out of the market.[69] Increased margins could also "minimize unwarranted switching of speculative accounts from one commodity or market to another."[70]

In a 1941 report, the CEA noted that the rules of most contract markets mandated that their members require the posting of margins by their customers. Only two exchanges did not have such requirements. These were the New York Wool Top Exchange and the Chicago Open Board of Trade.[71] In the Wool Top Exchange, there was some evidence that low margin requirements were used as a competitive device among brokerage firms. As a result, when customer margins were required, they were usually less than what the clearinghouse required for members. This arrangement differed significantly from the practice of a number of exchanges where compulsory customer margin requirements were often some multiple of the clearinghouse requirement.[72] Many brokerage firms, however, did not have margin requirements for customers' accounts trading in foreign markets; thus, credit was frequently extended to foreign accounts.[73]

The government's new-found belief that margin requirements could play an important role in the regulation of commodity futures trading was strengthened by events surrounding the outbreak of World War II. Prior to the attack on Pearl Harbor, the Department of Agriculture investigated the markets to determine the size and nature of speculative holdings. The concern was that, under emergency conditions, a sudden influx into the markets of small poorly-informed traders or panic liquidations of thinly margined accounts could greatly accelerate price swings. Therefore, several surveys were taken in various commodities in 1941.[74] One survey showed that there had been erratic price movements in soybean futures and a large volume of in-and-out trading, which was viewed as excessive speculation. This justified an increase of margins.[75] Thus, on Sunday, December 7, 1941, increased margin requirements, as well as other controls, were imposed by the exchanges at the government's request. These

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the possibility that speculators will accumulate large lines [of credit] if the anticipated profits appear to justify the advancing of large margins." P. Mehl, *Controlling Speculative Activity By Limiting the Size of Lines and the Trading* 1, 4 (Oct. 9, 1936).

69. COMMODITY EXCHANGE ADMINISTRATION, U.S. DEP'T OF AGRICULTURE, REPORT OF THE CHIEF OF THE COMMODITY EXCHANGE ADMINISTRATION 8 (1941).

70. *Id.* Interestingly, the Department of Agriculture opposed a bill, S.831, 76th Cong. 1st Sess. (1939), that would have authorized the Commodity Exchange Commission to fix margins at not less than 25%. The Department stated that standards established by the bill were not practical and that enforcement would be difficult and costly. The Department also pointed out that the bill applied only to those commodities then being regulated, and it was concerned that this would result in trading being switched to markets that were unregulated and which had lower margin requirements. *Senate Agriculture Comm. Hearings*, 76th Cong., 1st Sess. (1939), *noted in*, KAUFFMAN *supra* note 60, at 33.

71. U.S. DEP'T OF AGRICULTURE, CIRCULAR NO. 604, TRADING IN WOOL TOP FUTURES 9 (1941).

72. *Id.* at 10.

73. *Id.*

74. REPORT OF THE ADMINISTRATOR OF THE AGRICULTURAL MARKETING ADMINISTRATION, 74-75 (1942).

75. *Id.*

increases appeared to be effective in preventing undue market disturbances.[76] But this stabilizing effect did not long outlive the war.

In 1946, cotton prices quickly rose to unprecedented levels, then plummeted precipitously. In April, the Office of Price Administration ("OPA") decreed that margins on *new* speculative trades in cotton futures should be $50 a bale. Apparently, the head of OPA, Chester Bowles, ordered the Secretary of Agriculture to impose that requirement to prevent further speculative increases in cotton prices.[77] Thereafter, prices fell, and the CEA found that this price break was accentuated by the liquidation of thinly margined accounts and unwarranted extensions of credit to speculative traders. Indeed, nearly one-third of the traders in the market were liquidated when prices dropped. Most of these traders were speculators. The CEA believed that the small amount of margin initially required by the exchanges had lured into the cotton market small speculators, who did not have the financial resources to maintain their positions when the market dropped. The rapid liquidation of these thinly margined positions accelerated price increases and deepened price declines.[78]

An August, 1946 report prepared by the CEA concluded that the surge in speculative activity, particularly in the *cotton* market, came "after the increase in margins on *securities* transactions to 100 percent in January, 1946."[79] The government believed that the low margin levels set by the commodity exchanges had attracted speculators fleeing the government's efforts to curb speculation in the stock markets.[80] The CEA concluded that its efforts to prevent excessive speculation in the futures markets were impaired by its inability to control mar-

76. *Id.* at 68, 75.

77. *Commodity Futures Trading Commission Reauthorization: Hearings on S.2109 Before the Subcomm. on Agricultural, Research and General Legislation of the Senate Comm. on Agriculture, Nutrition, and Forestry*, 97th Cong., 2d Sess. 510 (1982). The report does not say why it was necessary for Mr. Bowles to order the Secretary of Agriculture to act. *Id.*

78. U.S. DEP'T OF AGRICULTURE, COLLAPSE IN COTTON PRICES OCTOBER 1946 1-4 (1947).

79. REPORT OF THE DIRECTOR, COMPLIANCE AND INVESTIGATION BRANCH, AND ADMINISTRATOR, COMMODITY EXCHANGE ACT, FISCAL YEAR ENDED JUNE 30, 1946, at 23 (1946) (emphasis supplied).

80. *Id.* The Secretary of Agriculture stated with respect to the October 1946 break in cotton prices that:

> It appears that the only way to prevent a price debacle following advances induced by overspeculation is to curb the speculative urge before it reaches the danger point. The only feasible means of doing this is through quick and somewhat arbitrary action in raising margins on speculative positions. It is believed that this could be done without serious loss of market liquidity necessary to facilitate hedging. It is doubtful whether the commodity exchanges can or will exercise margin control in such a manner as to be effective in curbing speculative excesses. Such action necessarily means a loss of commissions and income to brokerage houses . . . . The Federal Reserve Board is authorized to fix margins governing trading in securities and this power has been exercised to curb excessive speculation on the stock exchanges. No such authority is provided for in existing laws applicable to trading in commodities.

COMMODITY EXCHANGE AUTHORITY, U.S. DEP'T OF AGRICULTURE, REPORT OF THE ADMINISTRATOR OF THE COMMODITY EXCHANGE AUTHORITY 4 (1947) [hereinafter COMMODITY EXCHANGE 1947] (quoting letter from Clinton P. Anderson, Sec'y of Agriculture, to Congress (Mar. 26, 1947)). *See also Joint Committee Economic Rep. Hearings*, 80th Cong., 1st Sess. 2-3 (1947)

gin levels in commodities.[81]

The CEA also discovered that there had been a wide disparity in the margin requirements on the various cotton exchanges. For example, at one time, the Chicago Board of Trade required an initial margin for cotton of $5 per bale, while another exchange required $10 and still another $15 per bale. At another time, there was a disparity of $25 per bale for initial margin requirements. During this period, the volume of trading on the Chicago Board of Trade increased tremendously in relation to other exchanges. Later, the Chicago Board of Trade "continued to enjoy increased business even after margins on all three exchanges were equalized through governmental action."[82] To the government, this seemed to be clear evidence that low margin requirements attracted immediate business to the exchange; further, the government found that these new traders tended to remain with that exchange even after margins were equalized with other exchanges. The CEA believed that federal controls were necessary to prevent such competition from creating margin levels so low that excessive speculation would be encouraged.[83]

Dramatic price changes in the commodity markets in 1947 also troubled the CEA. Increased grain prices resulted in massive speculation and volatile markets. The CEA's concern with speculation in grain futures became particularly acute in February and March, 1947 because a large speculative interest had been attracted to the Chicago wheat futures markets by margin requirements of only eight to twelve percent.[84] On March 13, 1947, the Secretary of Agriculture called for corrective measures to curb speculative excesses on the futures markets.[85] The next day, the CEA specified those corrective measures by asking the exchanges to increase margins on speculative transactions to at least twenty-five percent.[86] The CEA stated that such increases were necessary to prevent a "speculative understructure of thinly margined accounts" held by traders who had been attracted to the markets by rapidly rising prices.[87] The CEA was concerned that if the market began to slip, large numbers of these small traders would be forced to sell their positions and that this in turn would accelerate price declines.[88] Two exchanges acceded to the request to increase margins; other exchanges did not.[89] Prices then decreased, but the "effect of the March increase in margins was largely nullified in May, . . . when the three exchanges again sharply reduced their requirements."[90] For example, the Kansas City

(discusses events in futures markets following World War II); *House Banking and Currency Comm. Hearings*, 80th Cong., 1st Sess. 90 (1947) (same).

81. COMMODITY EXCHANGE 1947, *supra* note 80, at 4.

82. REPORT OF THE DIRECTOR, COMPLIANCE AND INVESTIGATION BRANCH, AND ADMINISTRATOR, COMMODITY EXCHANGE ACT, FISCAL YEAR ENDED JUNE 30, 1946, at 23-24 (1946).

83. *Id.*

84. COMMODITY EXCHANGE 1947, *supra* note 80, at 4.

85. *Id.*

86. *Id.*

87. *Id.*

88. *Id.*

89. *Id.*; *1948 Hearings*, *supra* note 28, at 102-03.

90. COMMODITY EXCHANGE 1947, *supra* note 80, at 4.

Board of Trade reduced its requirements to about ten percent.[91]

In May and June, 1947, prices began to advance anew, and a large speculative interest was again attracted to the Chicago market. The CEA found, for example, that the bulk of traders in the Chicago corn futures market were speculators.[92] On September 15, 1947, the CEA again asked the exchanges to increase their margins—this time to 33-13 percent—to lessen the danger of a speculative boom and bust market.[93] The exchanges responded with a telegram to the Secretary of Agriculture asking for a conference so that they could urge him not to demand such an increase, which was nearly double existing margin requirements.[94] Thereafter, the exchanges increased their margins slightly, but not to the satisfaction of the government.[95]

On October 5, 1947, President Truman charged that "gambling in grain" was a factor contributing to the high price of food. The President asserted that ninety percent of all accounts in the corn futures market were speculative and that trading had risen from three or four million bushels a day to thirty million bushels a day. The President demanded that the grain exchanges increase their margin requirements to at least 33-13 percent. He threatened that, if the exchanges failed to comply with this request, the government would sharply limit the amount of trading that individual traders could conduct.[96] The exchanges promptly acquiesced in this Presidential demand. Still, although the volume of speculative trading in wheat and corn futures declined sharply,[97] prices continued to advance.[98]

President Truman's views on margins were not universally shared. For example, the publication *Barron's* asserted that in October of 1947 the futures markets had ignored a large margin increase imposed by the Chicago Board of Trade.[99] In fact, prices increased dramatically after the margin increase.[100] *Barron's* stated that this proved the futility of margin controls as a means of lowering prices. The publication also noted, however, that the government remained unconvinced.[101]

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91. *1948 Hearings*, *supra* note 28, at 103.
92. COMMODITY EXCHANGE 1947, *supra* note 80, at 4-5.
93. *1948 Hearings*, *supra* note 28, at 103.
94. *Id.*
95. COMMODITY EXCHANGE 1947, *supra* note 80, at 5.
96. *1948 Hearings*, *supra* note 28, at 103.
97. COMMODITY EXCHANGE 1947, *supra* note 80, at 5.
98. *1948 Hearings*, *supra* note 28, at 104.
99. Barron's, Oct. 6, 1947, at 36.
100. *Id.*
101. *Id.* One author stated that:

> The absence of federal margin requirements has to a large extent been made a scapegoat for food and other commodity price increases. Actually, these are chiefly the product of inflationary conditions connected with the present national emergency and crop outlook. Price trends of 1947-1948 under the 33 1/3% margins clearly indicate that increased margin requirements will not nullify the effects of these fundamental supply and demand factors. Efforts to control prices should therefore be aimed directly at these underlying factors, while margin controls should be restricted to their proper function of reducing price fluctuations which do not reflect basic market conditions.

E. Subsequent Unsuccessful Legislative Efforts to Impose Margin Controls

In 1948, hearings were held on legislation that would have authorized the Secretary of Agriculture to regulate margin requirements whenever the Secretary believed that speculation was causing or threatening "sudden or unreasonable fluctuations or unwarranted changes in the price of any commodities."[102] In the hearings, the Secretary of Agriculture, on behalf of the government, asserted that regulation of margin requirements would serve many objectives. First, such regulation would be an effective means of restraining undue speculative trading.[103] Second, during boom periods, increased margins would restrict speculative buyers with inadequate resources from entering the market.[104] Third, the government believed that increased margins would provide a cushion against forced liquidations that accentuated price declines, and would deter massive short selling in periods of falling prices.[105] The Secretary thus believed that margin controls would lend stability to the commodity futures market. The Secretary also noted that the boom in prices in the commodities markets had attracted small speculators from the real estate and stock markets, with "disastrous [results] for these small traders."[106] Moreover, there had been no stock market crashes since margin controls were imposed, and the securities markets had been relatively stable as a result of such controls.[107]

Other witnesses asserted that granting the federal government control over margin could destroy the futures markets.[108] These witnesses believed the danger was that the government could raise margins at any time. This power would be oppressive to the market by creating fears that government mandated increased margins could suddenly end or impair market liquidity.[109] Further, one exchange claimed that the Department of Agriculture wanted to use margins to regulate market prices. The exchanges believed, however, that margins should not be used for such a purpose.[110]

The legislation that was the topic of these hearings ultimately was not enacted. Nevertheless, the issue remained live. In February of 1949, a sharp drop in grain prices caused a large number of liquidations on the Chicago Board of Trade. The CEA determined that many small traders had their accounts concentrated on the long side of the market and that the liquidation of these ac-

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Note, *Federal Regulation of Commodity Futures Trading*, 60 YALE L.J. 822, 846-47 (1951). A representative of the Commodity Exchange Authority also testified that it was not practical to use trading limits to control speculation because such limits could not be made low enough to affect the general mass of minor traders without unduly restricting the speculative trading that is necessary to provide liquidity for hedging purposes. *House Banking and Currency Comm. Hearings*, 80th Cong., 1st Sess. 324, 325 (1947).

102. *1948 Hearings*, *supra* note 28, at 2.

103. *Id.* at 4.

104. *Id.*

105. *Id.* at 43.

106. *Id.* at 20.

107. *Id.* at 44.

108. *Id.* at 33.

109. *Id.* at 38.

110. *Id.* at 104.

counts, when prices initially began falling, was a major factor that accentuated the sudden drop in prices. Again, the CEA opinion that this large price break resulted from low margin requirements that allowed speculators with inadequate financial resources to enter the market. This was the same situation the CEA had found in previous investigations.[111] When traders entered markets with small margin requirements, they tended to acquire the largest position possible with the funds they had available. Upon the occurrence of any significant price declines, these small traders were forced to liquidate their positions, thereby causing a still larger drop in prices.[112]

These concerns may have been well-founded, as demonstrated by the enormous speculative operations that occurred at the outbreak of the Korean War. At that time, margin requirements were so low that traders were able to finance speculative transactions with relatively small down payments. The CEA again found speculative traders tended to buy the largest amount of futures their funds would allow; the lower the margin, the greater the inducement to buy larger amounts, which increased the potential effect on prices.[113] The CEA further argued that low margin rates were "advantageous to traders inclined to use profits from initial purchases to finance additional speculative buying. Speculation feeds on speculation."[114] In addition, commodity traders were "attracted by the prospect of profits from wartime price rises," and because of the leverage factor in futures trading they were able to "buy large amounts of futures by risking relatively small amounts of money."[115] Indeed, a speculator who traded on a minimum margin could have made profits of 100% to 450% in various commodities in a five week period.[116]

The CEA still believed that low margins were contributing to the upsurge of speculative activity and price increases, and noted that its inability to control margin requirements was in stark contrast to the regulation possible in the securities market. Minimum margins for speculative commodity accounts in June, 1950 ranged from six to thirteen percent for most commodities, while securities transactions had a uniform minimum of fifty percent.[117]

The outbreak of the Korean War led to renewed interest by President Truman in setting margin requirements. In a July, 1950 radio address, he stated that one of the major causes of inflation was the excessive use of credit; there-

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111. COMMODITY EXCHANGE AUTHORITY, U.S. DEP'T OF AGRICULTURE, REPORT OF THE ADMINISTRATOR OF THE COMMODITY EXCHANGE AUTHORITY 4 (1949).

112. *Id.*

113. COMMODITY EXCHANGE AUTHORITY, U.S. DEP'T OF AGRICULTURE, REPORT OF THE ADMINISTRATOR OF THE COMMODITY EXCHANGE AUTHORITY 7-8 (1950) [hereinafter COMMODITY EXCHANGE 1950].

114. *Id.* at 8.

115. *Id.* Futures contacts are leveraged, in that traders can trade with a small amount of money (margin) in relation to the volume of the commodity covered by the futures contract, the margin often being less than five percent. ASSOCIATION OF COMMODITY EXCHANGE FIRMS, INC., TRADING TECHNIQUES FOR THE COMMODITY SPECULATOR 2 (1963).

116. COMMODITY EXCHANGE 1950, *supra* note 113, at 8; U.S. DEP'T OF AGRICULTURE, CURRENT SPECULATION IN COMMODITY FUTURES 45 (1950), *noted in* 96 CONG. REC. 11,756 (1950).

117. COMMODITY EXCHANGE 1950, *supra* note 113, at 7-8.

fore, he was seeking to curb speculation in agricultural commodities.[118] On July 19, 1950, a bill entitled "The Defense Production Act of 1950" was introduced in Congress.[119] It provided for the regulation of commodity futures margins under the Commodity Exchange Act.[120] But this provision was later deleted from the bill. A substitute provision was then proposed that would have required the exchanges to limit excessive speculation at the request of the Secretary of Agriculture; it too was deleted after the commodity exchanges voluntarily increased their speculative margin rates for most commodities.[121] The CEA, however, believed that these rates were not sufficient to restrain speculation in periods of market excitement. The CEA stated that margin increases adopted by the exchanges after a large number of traders have already entered the market come too late to prevent price distortions.[122]

The exchanges were undaunted by CEA concerns. After the defeat of the Defense Production Act, they reduced their margin requirements. By June 30, 1951, speculative margins were about the same as they were in the year prior to the outbreak of the Korean conflict; that is, they ranged from six to fifteen percent for most commodities.[123] Later, these low levels were reduced even further.[124]

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118. N.Y. Times, July 20, 1950, at 15 (in preparation for Korean War, President Truman calls for curb to speculation in agricultural commodities to halt inflation).

119. 96 CONG. REC. 10, 570-76 (1950).

120. The amendment to the Defense Production Act bill would have authorized the President to promulgate regulations governing commodity futures margin requirements where speculative trading was causing or threatening to cause sudden or unreasonable price fluctuations. H.R. 9176, 81st Cong., 2d Sess. (1950). The amendment was approved by the House Banking and Currency Committee but was defeated on the floor of the Congress. 96 CONG. REC., *supra* note 119. H.R. Rep. No. 639, 82d Cong., 1st Sess. 1 (1951).

121. Note, *supra* note 101, at 824 n.1. Representative Boggs stated that the use of margins to control price increases has "no foundation in fact." 96 CONG. REC. 11,759 (1950) (remarks of Rep. Boggs).

122. COMMODITY EXCHANGE 1950, *supra* note 113, at 10.

123. COMMODITY EXCHANGE AUTHORITY, U.S. DEP'T OF AGRICULTURE, REPORT OF THE ADMINISTRATOR OF THE COMMODITY EXCHANGE AUTHORITY 8 (1951). On the other hand, effective January 17, 1951 as a result of the Korean conflict, securities margins were increased to 75 percent from 50 percent. 2 L. LOSS, SECURITIES REGULATION 1246 (2d ed. 1961).

124. COMMODITY EXCHANGE AUTHORITY, U.S. DEP'T OF AGRICULTURE, REPORT OF THE ADMINISTRATOR OF THE COMMODITY EXCHANGE AUTHORITY 11 (1952). This seems to have borne out a prediction by an article in *New Republic*, following President Truman's efforts to obtain margin controls. The author of the *New Republic* article stated that "five will get you ten from me that the views of the directors of the commodity exchanges will prevail in both the House and the Senate and that we will go into the next speculative binge without the controls asked by the President . . . . Lahey, *Fattening on Futures*, NEW REPUBLIC, May 21, 1951, at 11, 12.
Another author had responded to the CEA's concerns about speculative trading for the period 1946 through 1950 as follows:

> In most instances speculative accumulation was described in rising markets and speculative liquidations cited in declining markets. The arguments were persuasive until the circumstances of the cash commodity markets were examined. The boom in grain prices in 1947 was the result of a real shortage of grain induced by government buying for war relief. The collapse in 1948 was the result of oncoming large crops following a short crop year. The break in 1949 was associated with general economic stagnation that caused a decline in the

Not unexpectedly, these events did not end the government's concern with margins. For example, the potato futures market in August, 1952 had a "speculative boom and price spiral" and a subsequent price collapse. A CEA investigation determined that this indicated "once again, how rapidly increased speculative buying, stimulated by exaggerated rumors of market scarcity and a low margin requirement, can contribute to boom-and-bust conditions in a market."[125] The government therefore persisted in its efforts to obtain control over futures margins. Between 1948 and 1974, proposals to impose federal regulation of margins were raised in Congress and rejected on at least eight separate occasions.[126]

For example, in 1964, the Department of Agriculture unsuccessfully sought once again to amend the Commodity Exchange Act to grant the department authority to fix margin requirements.[127] Then, in 1966, the CEA urged the Chicago Board of Trade to increase margin levels to deter excessive speculation. The Chicago Board of Trade declined to do so.[128] Thereafter the Secretary of Agriculture sought legislation that would authorize the government to control margins.[129] The legislation proposed in 1966 would have allowed the Secretary of Agriculture to prescribe minimum margin requirements and to make special provisions for carrying accounts that were undermargined, so that the sudden dumping of speculative positions through forced liquidation could be reduced. But the government would not have established minimum margin requirements under ordinary circumstances. Only when there was a danger of manipulation or sudden or unreasonable fluctuations in commodity prices or excessive speculation would it have been necessary for the government to establish margins that would "retard the buildup of positions or reduce them to protect the users of the market and the public." Such authority would have been used infrequently and only in "extreme circumstances."[130]

> demand for grain. The 1950 soybean boom was partly the result of short supplies relative to requirements, partly the outbreak of the Korean war, and had manipulative overtones relative to large positions held by a group of Chinese.

T. HIERONYMUS, *supra* note 12, at 319. For a discussion of the trading by Chinese traders, *see* U.S. DEP'T OF AGRICULTURE, SPECULATION IN SOYBEANS (August 10, 1950); COMMODITY EXCHANGE 1950, *supra* note 113, at 14.

125. COMMODITY EXCHANGE AUTHORITY, U.S. DEP'T OF AGRICULTURE, REPORT OF THE ADMINISTRATOR OF THE COMMODITY EXCHANGE AUTHORITY 5 (1953).

126. *Silver Prices and the Adequacy of Federal Actions in the Marketplace, 1979-80: Hearings Before A Subcomm. of the House Comm. on Government Operations*, 96th Cong., 2d Sess. 103 (1980).

127. *Price Volatility in the Silver Futures Market: Hearings Before the Subcomm. on Agricultural Research and General Legislation of the Senate Comm. on Agriculture, Nutrition and Forestry*, 96th Cong., 2d Sess., pt. 1, at 425-26 (1980) [hereinafter *Senate Silver Price Volatility Hearings*] (statement of Lee H. Berendt, President, Commodity Exchange, Inc.).

128. *Agriculture-Environmental and Consumer Protection Appropriations for 1974: Hearings Before a Subcomm. of the House Comm. on Appropriations*, 93d Cong., 1st Sess., pt. 4 (1973).

129. *To Amend the Commodity Exchange Act: Hearings on H.R. 11788 Before the House Subcomm. on Domestic Marketing and Consumer Relations of the Comm. on Agriculture*, 89th Cong., 2d Sess. (1966) [hereinafter *1966 Hearings*].

130. *Id.* at 12, 21. The Department of Agriculture did not seek margins comparable with those in securities transactions. It believed that such high margins "could seriously impair the operation

The exchanges argued in response that Congress should not give this authority to the Department of Agriculture because the purpose of margins "is not the control of credit as in the case of securities, but rather is and has been to provide protection to members of the Commodity Exchange insuring that the financial commitments of futures traders will be fulfilled."[131] The exchanges noted that they closely monitor margin levels, and that the factors involved in setting margins vary frequently, sometimes on an hourly basis.[132] They further argued that higher margins would decrease participation in the markets and increase costs for hedgers, and that there was no general agreement that higher margins would control the price of commodities.[133]

As a result of this opposition, Congress never adopted the proposed 1966 legislation. Nevertheless, legislation that would have given the Board of Governors of the Federal Reserve System authority to control credit in futures transactions was again sought in 1967, under a proposed consumer credit protection act.[134] But that provision also was not adopted after the Vice Chairman of the Federal Reserve Board recommended against its inclusion.[135] A 1966 study by the Department of Agriculture (the "*Nathan Study*")[136] also revealed that margin requirements would not be useful in controlling speculation and that raising margins could actually harm hedgers, without reducing market upswings.[137] The Nathan Study sought to test whether legislation allowing the government to control low margins would preclude the excessive speculation that produced erratic price fluctuations.[138] It concluded that, while investigations of futures markets twenty years earlier had shown that speculators played an important role in price making, hedgers had since come to play a major role in active markets.[139] Moreover, although the study found that between 1947 and 1948, high initial margin requirements "probably in fact helped curtail very short-term fluctuations,"[140] it also noted that speculative transactions often moderate rather than accentuate price volatility. The Nathan Study further stated that,

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of the futures markets and limit the usefulness of these markets for hedging and price-registering purposes." *Id.* at 12.

131. *Id.* at 44 (letter from Ray V. Edwards, Wilson & Co. to Harold D. Cooley (Mar. 28, 1966)).

132. *Id.* at 48 (statement of Robert L. Martin, Chairman, Chicago Board of Trade).

133. *Id.* at 50.

134. 113 CONG. REC. 19,615 (1967); *Senate Silver Price Volatility Hearings, supra* note 127, at 426.

135. *Hearings on H.R. 11,601 Before the Subcommittee on Consumer Affairs of the House Comm. on Banking and Currency*, 90th Cong., 1st Sess. 130-31 (1967) [hereinafter *Hearings on H.R. 11,601*] (Department of Agriculture more appropriate agency to administer commodity market); *Senate Silver Price Volatility Hearings, supra* note 127, at 427.

136. This report was prepared by Robert R. Nathan Associates Inc. under a contract with the Department of Agriculture. U.S. DEP'T OF AGRICULTURE, ECONOMIC RESEARCH SERVICE, MARGINS SPECULATION AND PRICES IN GRAINS FUTURES MARKETS (Dec. 1967) [hereinafter NATHAN STUDY].

137. *Id.*

138. *Id.* at i.

139. *Id.* at 1.

140. *Id.*

given the lack of data, the CEA "would find it difficult to determine whether, when, and how to apply margin controls to limit price volatility."[141] Nevertheless, legislation was introduced in the House of Representatives in 1973 as part of the amendments to the Economic Stabilization Act, that would have given the Federal Reserve Board authority over margin. That amendment was deleted on the House floor.[142]

F. Reversal of CEA's Position

Despite the numerous rebuffs to the government's efforts to obtain margin authority, the issue remained very much alive, particularly after prices in the commodity markets virtually exploded in the early 1970s.[143] During that pe-

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141. *Id.* One author commented on the NATHAN STUDY:

> It is not clear that margin levels could not be used to control speculation. In its final recommendations, the study does suggest that federal interference in setting margin levels would be unwise. This recommendation is based in part on evidence that small increases in margin levels have tended to correspond with increased market volatility. The study cautioned, however, that the correlation may have occurred because the margin increases were made when greater fluctuations were expected, or because many brokers did not comply with the changes in margins, which the exchanges were lax in enforcing. If the federal authorities had enforced the margin changes, the study noted, the results might have been different. Furthermore, in the one instance when large increases in margin requirements were made, there was a prompt reduction in price fluctuations. And, as the study points out, it is only when major margin changes are needed that federal authorities are likely to intervene.

Note, *The Role of the Commodity Futures Trading Commission Under the Commodity Futures Trading Commission Act of 1974*, 73 MICH. L. REV. 710, 754 (1975) (footnotes omitted) [hereinafter *Role of CFTC*].

142. 119 CONG. REC. 12,550-52 (1973); *Senate Silver Price Volatility Hearings*, *supra* note 127, at 427.

143. Futures trading had quadrupled in the five years preceding 1974. 120 CONG. REC. 2924 (1974) (remarks of Rep. Poage). And, in 1973, the futures markets had experienced "an unprecedented volume of trading at record prices . . . ." H.R. REP. NO. 975, *supra* note 10 at 67. Enormous profits could have been made in the early 1970s through the highly leveraged, low margin futures markets:

> [I]n order to speculate on an $18,000 futures contract for 40,000 pounds of cattle on the Chicago Mercantile Exchange, the margin requirement was only $700. On what was at that time a $15,000 contract on the Chicago Board of Trade for 100,000 board feet of stud lumber, the margin set by the exchange was only $500. On the New York Commodity Exchange a speculator on what was then a $16,500 contract for 25,000 pounds of copper had to put down only $750.
>
> Incidentally, a copper futures contract for which a speculator had to put down only $750 in April, 1973 is today worth approximately $33,000 because the price of copper has doubled in the meantime and that is a pretty good return of $16,000 on an original investment of only $750. It is because such truly phenomenal profits can be, and have been made in commodity futures trading with so little money down that the phenomena of widespread public speculation has occurred in these markets, particularly during the past year when the stock market has been in the doldrums and commodity prices seemed for a long time to going only in one direction. But, of course, for every winner on these commodity exchanges, there is also a loser and losses can be extremely heavy too.

120 CONG. REC. 2850 (1975) (statement of Rep. Sullivan).

A House Report stated that investors were migrating from the securities markets into the fu-

riod price fluctuations in the futures markets were "so wide and erratic" as to disrupt orderly marketing procedures, and they made the futures markets "unreliable devices for producers and processors to protect themselves against cost increases or price declines."[144] Representative Sullivan claimed that "inadequate controls over commodity futures speculation in farm commodities have resulted in price increases" that "hurt the American family grievously and particularly the lower income families and those on fixed incomes."[145] She charged that the futures markets were attracting "outsiders with little or no knowledge about the individual commodities but with loose money with which to gamble."[146]

Moreover, Representative Sullivan claimed that there was a "clear" conflict of interest on the part of the exchanges in setting margin requirements. "They have little or no interest in dampening down speculation during an inflationary situation because the more speculators who move into commodities in order to gamble, the more the exchange and its members make in commissions."[147] She also argued that margin levels "should reflect national economic conditions rather than just the self-interest of the exchanges, for it is to the exchanges' interest, usually, to set the margin levels which would attract as many new customers as possible, and those are levels which are often far too low for national economic stability."[148]

In 1973 and 1974, there were renewed legislative efforts to address the market conditions and related concerns.[149] For example, in 1973, a witness at the

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tures markets because they were being "attracted by price leverage, low margin requirements, [and] volatile price action." The number of securities traders were decreasing as the number of futures traders increased. H.R. REP. NO. 975, *supra* note 10, at 39. Representative Sullivan stated that: "There are people looking for fast action on which large amounts of money can be made overnight with modest investments based on the exchanges' traditionally low margins, often as low as five percent, or even less, of the value of the contracts traded." 120 CONG. REC. 2849 (1974) (statement of Rep. Sullivan).

144. 120 CONG. REC., *supra* note 143 (statement of Rep. Sullivan).

145. *Id.*

146. *Id.*

147. *Id.*

148. *Id.* Representative Sullivan further stated that:

> If the New York Stock Exchange had the opportunity today to set minimum margins on common stocks, as the commodity exchanges do on futures contracts, it is probable that the margin on stocks would also now be only 5 percent instead of 50 percent in order to stimulate more trading. But we learned in the 1929 Stock Market Crash that when margin setting is left to the exchanges themselves and to individual brokers, margins are not based on any consideration of national interest. That has been the case in commodities.

Id. See also, 120 CONG. REC. 2953 (1974) (statement of Rep. Sullivan).

149. *See Commodity Futures Trading Commission Act of 1974: Hearings Before the Comm. on Agriculture on H.R. 11955*, 93d Cong., 2d Sess. 2-8(1974) [hereinafter *House CFTC Hearings*] (testimony of Rep. Neal Smith, sponsor). *See generally Agriculture-Environmental and Consumer Protection Appropriations for 1974; Hearings Before a Subcomm. of the House Comm. on Appropriations*, 93d Cong., 1st Sess., pt. 4, at 386-529 (1973); *Commodity Futures Trading Commission Act: Hearings Before the Senate Comm. on Agriculture and Forestry on S. 2485, S. 2578, S. 2837, and H.R. 13113*, 93d Cong., 2d Sess. (1974) [hereinafter *Senate CFTC Hearings*]; *Review of Commodity Exchange Act and Discussion of Possible Changes: Hearings Before the House Comm. on Agriculture*, 93d Cong.,

hearings before a House Subcommittee recommended that the federal government be given margin control authority. This would not require, however, that legitimate hedgers would have to post the same amount of margins as speculators.[150] Oddly, the principal motivating factor for these renewed demands for federal margin authority was the fact that the exchanges had *raised* their margin requirements unexpectedly as a result of rapid price increases.[151] Propenents of legislation believed that raising margins had an undue and unfair effect on hedgers because it increased their interest costs since they had to borrow funds to pay the increased margins.[152] "The result of this is undoubtedly to decrease the amount farmers receive for a product and also to increase the cost so the ultimate consumer."[153] Under this view, it was improper for the exchanges to change margin requirements after a contact had been trading, because this would hurt hedgers more than speculators when prices increased. This concern was especially relevant "in a rising market where speculators trading the long side of the market were making huge profits and hedgers on the short side of the market were required to put up more money for margin calls."[154]

The hearings on the proposed legislation showed the CEA switching positions on the margin issue. The CEA testified in Congress that stocks and commodity futures margins were "as different as apples and oranges" and that increasing margin requirements was "an ineffective means of curbing volatile prices and can increase the extent of a price movement rather than dampen

1st Sess. (1973); *Review of Commodity Exchange Act and Discussion of Possible Changes: Hearings Before the House Comm. on Agriculture*, 93d Cong., 1st Sess. (1973); *Russian Grain Transactions: Hearings on Russian Grain Transactions Before the Permanent Subcomm. on Investigations of the Senate Comm. on Government Operations*, 93d Cong., 1st Sess., pt. 1 (1973). *Small Business Problems Involved in the Marketing of Grain and Other Commodities: Hearings Before the Subcomm. on Special Small Business Problems of the House Permanent Select Comm. on Small Business*, 93d Cong., 1st Sess. 21 (1973) [hereinafter *Hearings on Small Business Problems*]

150. 120 CONG. REC., *supra* note 148; *see Hearings on Small Business Problems*, *supra* note 149. The chairman of the Small Business Committee later changed his position on this issue. *Senate Silver Price Volatility Hearings*, *supra* note 127, at 433-34.

151. The commodity exchanges' margin increases were dramatic. During the May-June period in 1973, initial margin requirements were increased by about 300% and maintenance margins were increased 250%. Smith, *Commodity Futures Trading*, 25 DRAKE L. REV. 1, 14 (1975). This resulted in liquidating transactions, which increased demand pressure even more and caused still higher prices. *Id.* at 15. It also disrupted short hedging on the market, as hedgers tried to obtain funds to meet margin calls at increased interest costs. *Id.* *Cf.* H.R. REP. NO. 963, 93d Cong., 2d Sess. 21 (1974) (federal oversight required to prevent exchange from raising margins during periods of market fluctuation to detriment of hedgers).

The exchanges have repeatedly adjusted margin levels. This has resulted in charges of discriminatory practices and initiation of legal actions. The exchanges also have been criticized frequently for not raising margin levels high enough or soon enough to prevent excessive speculation. H.R. REP. NO. 975, *supra* note 10, at 67; Note, *Margin Regulations, The Stock Market Crash of 1987*, 20 RUTGERS L. J. 693, 715 nn.124, 125 (1989).

152. *Review of the Commodity Exchange Act and Discussion of Possible Changes, Hearings Before the House Comm. on Agriculture*, 93d Cong., 1st Sess. 6-7, 36-48 (1973) [hereinafter *1973 House Hearings*].

153. *Id.* at 7.

154. *Id.*

it."[155] The CEA Administrator stated that higher margin requirements could also interfere with hedging and cause increased merchandising and processing costs.[156] The CEA, thus, adopted the exchanges' position that the regulation of commodity futures margins should be in the sole domain of the exchanges and not be set cooperatively with the government. The CEA conceded that the proper role of margins was to protect the exchanges.[157] Nevertheless, the Justice Department advised Congress that it seriously questioned "whether a regulatory agency can adequately police undue speculative activity without some input into the margin equation."[158] The Comptroller General advocated studying the feasibility of a margin formula or table for each commodity so that traders would be on notice of the automatic margin changes that would be implemented when prices increased.[159] The National Grain Federal Association thought that such tables would alleviate charges that the exchanges were imposing discriminatory margin requirements.[160] The Comptroller further suggested that the government be given residual margin authority under the Commodity Exchange Act to prevent the exchanges from changing margins a way that

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155. *Id.* at 26.

156. *Id.* The CEA Administrator further noted that:

> If you have a situation in which the price is going up and has been going up for a substantial period of time and you raise margins, the people on the long side of the market have plenty of profits already accumulated and they do not have to put up any additional funds. The people on the short side, who have been losing money when prices have been rising, are forced to put up additional funds and in many cases are unable to do so. The only solution is to get out of the futures position. The only way they can get out of these positions is buying offsetting futures contracts. This additional buying could add another impetus to the upward movement of prices.

Id. at 36. The supporters of legislation seemed to focus more on the raising of margin requirements after a futures contract is entered into, rather than on the initial rate. *See supra* notes 151-54 and accompanying text for a discussion of the views of federal control supporters.

157. The CEA stated that:

> In commodity futures markets, margin is required to protect the brokerage firm against loss resulting from adverse price movement and the inability or unwillingness of the customer to provide funds to cover the loss. This, in my opinion, is not a matter requiring action by the government. I would also be opposed to a provision prohibiting changes in margin requirements after it has been established for a particular contract. If price fluctuations increase while a particular contract is being traded, margin should be increased for the protection of the brokerage firms and indirectly for the protection of their customers. On the other hand, if price fluctuations decrease, margins should be lowered to less than the cost of trading by hedgers and others in the market.

1973 House Hearings, *supra* note 152, at 38-39. It is unclear why the CEA changed its position; possibly it wanted to enlist the exchanges in supporting its survival.

158. 120 CONG. REC. 2952 (1974); Letter from Malcolm D. Hawk, Acting Assistant Attorney General, to Rep. Poage, Chairman, House Comm. on Agriculture (Jan. 30, 1974) [hereinafter Letter Malcolm D. Hawk], *reprinted in* H.R. REP. NO. 975, *supra* note 10, at 26-27.

159. COMPTROLLER GENERAL, INTERIM REPORT TO THE CONGRESS ON THE CEA AND ON COMMODITY FUTURES TRADING 26 (May 3, 1974) [hereinafter INTERIM REPORT]; 120 CONG. REC. 2952, *supra* note 158. Exchange members sometimes were interested financially in margin changes because they had positions in the market. *House CFTC Hearings*, *supra* note 149, at 6.

160. INTERIM REPORT, *supra* note 159, at 26.

would favor exchange members to the disadvantage of hedgers.[161]

As might be expected, the exchanges again opposed all efforts to impose federal regulatory control over commodity futures margins. In response to the Comptroller General's proposal for adopting a formula for margin requirements, the exchanges asserted that it was not possible to establish any such formula.[162] The exchanges further argued that the *Nathan Study* had concluded that margin adjustments are an ineffective and probably counterproductive device for controlling speculation.[163] They also pointed out the irony in now being criticized for raising margins in the face of increasing prices while in the past they had been criticized for failing to raise margins in the face of similar price increases.[164] As always, the exchanges argued that margin "is not a vehicle for either limiting or promoting trading in futures."[165] Rather, it was for the protection of the exchanges.[166] They contended that placing margin control authority in the hands of the government would "effectively destroy futures trading."[167]

The experience of the exchanges suggested that increasing margin requirements would amplify the intensity of price movements, because short traders would have to make liquidating purchases if they could not meet their margin calls.[168] The industry was concerned that increased margins would reduce the effectiveness of the market place and thereby disrupt the operations of hedgers.[169] One prominent exchange official asserted that, if margin authority was used for anything other than to act as a security deposit, the power would be used to create artificial price movements that would place the country on the threshold of price controls.[170]

Another exchange argued that if a federal agency obtained margin authority, it would set margins unnecessarily high and would seek to use margins as a tool to curb speculation. This would make the use of the market prohibitive to hedgers. Furthermore, margin changes would "not be made as quickly as needed because government agencies have a tendency to move slowly."[171] Finally, the National Grain Trade Council opposed federal margin controls because it believed that such controls could "cause a breakdown in the entire grain

161. *Id.*

162. *1973 House Hearings, supra* note 152, at 76. *Cf. id.* at 48 (testimony of Robert W. Richards, National Grain & Feed Ass'n) (study would show safe margin levels to be function of price and trading conditions).

163. *Id.* at 48. *See also id.* at 76, 110, 193.

164. *Id.* at 48.

165. *Id.* at 19-20.

166. *Id.* at 96.

167. *Id.* at 109; *Senate CFTC Hearings, supra* note 149, at 318, 447, 493-94.

168. *1973 House Hearings, supra* note 152, at 110-11. The CEA argued that because speculators' transactions often moderated price volality, any margin controls reducing speculative activity would diminish the moderating effect. *Id.*

169. *Id.* at 136. Domestic exchanges feared that hedgers and speculators would shift their trading to international markets with lower margin requirements. *Id.* at 111.

170. *Senate CFTC Hearings, supra* note 149, at 337 (statement of Leo Melamed). *See also 1973 House Hearings, supra* note 152, at 192 (statement of Leo Melamed).

171. *Senate CFTC Hearings, supra* note 149, at 414.

marketing structure."[172] It asserted that raising margins would not prevent prices from increasing, noting that commodities which had no futures markets usually had more erratic price behavior than those that had futures trading.[173]

G. Further Rejection of Federal Control over Futures Margins

One bill introduced in Congress during the early 1970s provided for the creation of the CFTC. This bill would have authorized that agency to set margins.[174] But the House of Representatives ("House") Agriculture Committee denied this authority to the CFTC in a bill it reported out.[175] That committee believed that the federal government did not have the capability to establish and monitor margin requirements on a day-to-day basis. It noted that the *Nathan Study* had also concluded that the government was not qualified to conduct such a task.[176] The committee stated, however, that Congress should consider whether the agency administering the Commodity Exchange Act should have the authority to set margins under emergency market conditions.[177]

Nevertheless, Representative Vanik offered an amendment on the House floor that would have allowed the CFTC to "act effectively to prevent excessive speculation in futures trading by having the power to deal with the fixing of margins."[178] Representative Vanik stated that unless this authority were granted it would "be impossible to prevent the tremendous speculation that is taking place in commodities."[179] That amendment, however, was beaten back by Representative Poage, one of the principal sponsors of the legislation that created the CFTC. He argued that margins in the futures industry were for the protection of the exchanges and not for the protection of individuals.[180] He noted that conditions on the markets could change hourly and that, if margin-setting authority were taken away from an exchange, it would be deprived of "the very essential power to protect itself from bankruptcy. If one establishes a business that cannot protect itself, one brings about disaster very quickly."[181] Poage stated that it would be "very unwise" and "very unfair" to remove the

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172. *Id.* at 780 (statement of William F. Brooks).

173. *Id.* A National Grain Trade Council representative stated that: "By raising margins you can reduce and eliminate volume of trading. But you cannot control prices. And you might wreck the market structure." *Id.*

174. *House CFTC Hearings*, *supra* note 149, at 6 (statement of Rep. Neal Smith).

175. H.R. REP. NO. 975, *supra* note 10, at 66.

176. *Id.* at 67. *See supra* notes 136-41 for a discussion of the *Nathan Study*.

177. H.R. REP. NO. 975, *supra* note 10, at 67. The House Agriculture Committee also noted that the National Grain and Feed Association ("NGFA") and the Comptroller General had suggested studying whether a schedule of margin levels could be established so that traders could have advance warning of automatic margin changes. The House Committee did not demand the establishment of a margin schedule, although it left open the possibility of further study. *Id. See supra* notes 159-161 for a further discussion of the recommendation of the Comptroller General and the NGFA.

178. 120 CONG. REC., *supra* note 158 (statement of Rep. Vanik).

179. *Id.*

180. 120 CONG. REC., *supra* note 148 (statement of Rep. Poage).

181. *Id.*

authority of the exchanges to set margins for their own protection.[182] Poage's arguments prevailed. But Congress did conclude that the CEA was no longer equipped to regulate the futures markets, which had expanded into such nontraditional areas as futures contracts on precious metals and foreign currency.[183] The Commodity Exchange Act, therefore, was amended to create the CFTC and to grant it far reaching powers.[184] Congress, however, expressly denied the CFTC authority to regulate margins.[185]

H. The Changing Nature of the Futures Markets and the Reemergence of the Margin Issue

In the early 1970s, the commodity exchanges had begun the development of futures contracts on a wide variety of products, including items that intruded into the traditional realm of securities regulation.[186] These included futures contracts on Government National Mortgage Association ("GNMA") Certificates, on index items such as stock indexes, and on government securities.[187] The CFTC was given exclusive jurisdiction over such futures contracts.[188]

Shortly after its creation, the CFTC approved the first of these securities related products for futures trading—the GNMA futures contract on the Chicago Board of Trade. Although the SEC objected to the CFTC's assertion of exclusive jurisdiction over such futures contracts, GNMA futures contracts continued to trade under the CFTC's exclusive authority. This touched off a long, continuing battle between the SEC and the CFTC over jurisdictional turf.[189]

One skirmish occurred in 1978, when the CFTC was required by its authorizing statute to seek reauthorization from Congress, pursuant to a "sunset" provision.[190] At that time, the SEC sought to obtain a portion of the CFTC's jurisdiction by expanding the definition of a security under the federal securities laws to include futures contracts for commodity options involving securities, including indexes of securities.[191] In a similar vein, the Treasury Department

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182. *Id.*

183. H.R. Rep. No. 975, *supra* note 10, at 36-39; S. Rep. No. 1131, 93d Cong., 2d Sess. 19 (1974).

184. Commodity Futures Trading Commission Act of 1974, Pub. L. No. 93-463, § 1, 88 Stat. 1389 (1974) (codified in scattered sections of 7 U.S.C.).

185. *See* 7 U.S.C. § 7a(12) (CFTC must approve exchange rules, except those relating to setting margins). The CFTC, however, has peripherally regulated margins for futures contracts. *E.g.* 17 C.F.R. § 1.58 (1990) (brokerage firms required to collect margins on gross basis for omnibus accounts).

186. S. Rep. No. 1131, *supra* note 183.

187. Chicago Board of Trade, Commodity Trading Manual 6-7 (1989).

188. 7 U.S.C. § 2.

189. *See Securities Exchange Commission - Commodity Futures Trading Commission Jurisdictional Correspondence*, [1975-1977 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 20,117 (1975) (both agencies discuss respective views on scope of CFTC jurisdiction).

190. Gaine, *The 1978 Sunset Review of the CFTC: Analysis and Comment*, 34 Rec. Bar Ass'n of City of N.Y. 290 (April 1979) (CFTC funding under sunset provision would require repeated reauthorization, ensuring continued congressional oversight).

191. S. Rep. No. 850, 95th Cong., 2d Sess. 19-20 (1978).

sought the right to approve or disapprove of futures contracts on governmen securities. Concerned with potential futures market abuses that could affec trading in government securities,[192] the Treasury Department also wanted au thority to suspend trading in futures contracts on those securities.[193]

The CFTC vigorously resisted this jurisdictional encroachment by the SEC and the Treasury Department. The CFTC argued, among other things, that a principal reason for not transferring CFTC functions to the SEC was tha "three-fourths of all futures trading activity is in agricultural commodities anc such trade serves a vital role in the marketing of those commodities."[194] Th Chicago Board of Trade Clearing Corporation also noted that volatile marke conditions required rapid response by clearing members; for example, they coulc be required to deposit large amounts of funds within one hour.[195]

The CFTC was successful in preventing the Treasury Department from ob taining any of its jurisdiction in 1978.[196] Nevertheless, a provision was added tc the Commodity Exchange Act which provided that the CFTC was to maintain

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192. *Id.* at 50. Robert Carswell, the Deputy Secretary of the Treasury Department, stated:

> The low margin required for purchasing a futures contract based on Government securities enhances the potential for abuses. Individuals and institutions can speculate with a small amount of money - a $1200 initial margin permits an investor to purchase a $1,000,000 Treasury bill futures contract - in return for the opportunity of reaping a proportionately large profit or suffering a proportionately large loss. The low margin requirement, in conjunction with the risk free nature of Government securities, could result in, or indeed encourage excessive speculation.
>
> Any speculative abuse could have an adverse effect psychologically on investor's perceptions of the underlying Government securities. That could only result in higher cost financing and potential impairment of the efficiency and resiliency of the Government securities market.

Id.

193. S. REP. NO. 850, *supra* note 191.

194. *Reauthorization of the Commodity Futures Trading Commission, Hearings Before the Subcomm. on Agricultural Research and General Legislation of the Senate Comm. on Agriculture*, 95th Cong., 2d Sess., pt. 2, 251 (1978) [hereinafter *1978 Senate Reauthorization Hearings*] (statement of Read P. Dunn, Jr.). Today the majority of all futures contracts involve financial instruments such as stock index futures. *See*, Futures Industry Association, *Trading Volume*, FIA REVIEW 5 (July/Aug. 1990).

Market makers in securities and securities options exchanges are normally permitted larger extensions of credit than other market participants. Those market makers could abuse those privileges by extending their lower margin requirements to other traders with whom they shared joint accounts - suggesting that even the securities markets had loopholes through which low margin trading levels could be enjoyed. *1978 Senate Reauthorization Hearings, supra*. *See also* 96 CONG. REC. 11,756 (1950) (commodity floor traders generally not subject to exchange margins).

195. *See, e.g., Extend Commodity Exchange Act, Hearings Before the Subcomm. on Conservation and Credit of the House Comm. on Agriculture on H.R. 10285*, 95th Cong., 2d Sess. IV, V, at 451, 470-71 (1978) [hereinafter *1978 House Extend Hearings*] (variation calls topped $4 billion in 1977). *Cf.* OCTOBER 1987 MARKET BREAK, *supra* note 20, at 5-12 to 5-13 (more than $11 billion in margin calls made by exchanges during the stock market crash of 1987 in four day period). *See also 1978 House Extend Hearings, supra*, at 398-99 (discusses CFTC's resistance to SEC encroachment). *See generally id.* at 182-210, 211-29 (positions of SEC and Chicago Board Options Exchange).

196. *See generally 1978 Senate Reauthorization Hearings*, supra note 194; *1978 House Extend Hearings, supra* note 195.

communications with the SEC, the Treasury and the Federal Reserve Board, and that the CFTC was to consider the views of the latter two agencies in approving applications for trading futures in government securities. Pointedly, consideration of the SEC's views on this latter point was not required.[197]

Still the issue would not die. In 1980, Congress was once again forced to consider whether the government should be given control over margin requirements to control the flow of credit and to limit excessive speculation. The resurrection of this issue was a result of the so-called silver crisis, involving the Hunt family of Dallas, Texas.[198] During this crisis silver prices increased rapidly from about nine dollars per ounce in August 1979 to over fifty dollars an ounce in January 1980. Before the price peaked, and after prodding by the CFTC, the exchanges increased margin levels to 100% and imposed strict limits on the size of speculators' positions. This dried up liquidity in the market, and prices then plunged to a low of $10.80 in March 1980. At that time, the Hunts and several other large speculators failed to meet their margin calls.[199] This, in turn, threatened the financial stability of six major brokerage firms, which could have lost hundreds of millions of dollars.[200] A national financial crisis was narrowly averted.[201]

Speculators in silver and other precious metals had also diverted needed credit from industries and consumers, prompting the Federal Reserve Board to direct banks not to issue loans on speculative trades.[202] The SEC was shocked

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197. Pub. L. No. 95-405, 92 Stat. 865 (1978) (currently codified as amended at 7 U.S.C §§ 4(a)(g)(2)(i) and 4(a)(g)(2)(ii)); H.R. REP. No. 1181, 95th Cong., 2d Sess. 32-34 (1978); H.R. REP. No. 1628, 95th Cong., 2d Sess. 17 (1978).

198. REPORT OF THE STAFF OF THE SECURITIES AND EXCHANGE COMMISSION, THE SILVER CRISIS OF 1980 4-14 (1982) [hereinafter SEC SILVER REPORT]. The Hunt Family increased its silver holdings to approximately $6.6 billion. *Id.* at 4. Half the acquisitions were leveraged with small margin deposits. *Id.* at 4-5. The Hunts had leveraged their physical silver holdings by borrowing against bullion that they owned. *Id.* at 5. Rapidly declining prices generated margin calls on the Hunts' net long futures position and required additional bullion deposits to maintain mandated collateralization ratios on their loans. *Id.* at 7. *See* H.R. REP. No. 565, 97th Cong., 2d Sess., pt 2 (amendment to CFTC jurisdiction); H.R. REP. No. 626, 97th Cong., 2d Sess. 3, pt. 2 (1982) (report discussing jurisdiction of SEC to cover, among other things, stock indexes).

199. SEC SILVER REPORT, *supra* note 198, at 7.

200. *Id.* at 10; *SEC Staff Faults Brokers in Report on '80 Silver Crisis*, N.Y. Times, Oct. 21, 1982, at D4, col. 1 [hereinafter *SEC Staff Faults Brokers*].

201. *See*, *CFTC Report to Congress in Response to Section 21 of the Commodity Exchange Act*, Pub. L. No. 96-276, 2d Sess. § 7, 94 Stat. 542 (June 1980). *See generally* SEC SILVER REPORT, *supra* note 198; H. REP. No. 565, *supra* note 168, pt. 1, at 61-71; H.R. REP. No. 395, 97th Cong., 1st Sess. (1981); S. FAY, BEYOND GREED (1986); *SEC Staff Faults Brokers*, *supra* note 200, at D4, col. 1.

The SEC staff stated that these events caused concern that there could be a serious disruption of the American financial system. SEC SILVER REPORT, *supra* note 198, at 3-4. Further, the Federal Reserve Board had to endorse a $1.1 billion loan to the Hunts to pay for their margin calls and other silver obligations. *Silver Prices and The Adequacy of Federal Actions in the Market Place, 1979-80, Hearings Before a Subcomm. of the House Comm. on Government Operations*, 96th Cong., 2d Sess. 219, 257 (1980) [hereinafter *Hearings on Silver Prices*].

202. *Hearings on Silver Prices*, *supra* note 201, at 207. The Board, however, directed this action not only at silver but also at a number of other volatile markets. *Id.*

to discover that the futures positions carried on the books of broker dealers it regulated were not being priced at their actual value. Instead, the book values were set at exchange price limits. This substantially understated the potential liability of the brokerage firm carrying the position in the event of a customer default.[203] The SEC Chairman testified before Congress that the events in the silver market had caused brokerage firms to face substantial financial exposure, and that the silver crisis threatened to have a significant adverse effect on the securities industry.[204]

Federal government regulation of margin requirements in commodities trading was again suggested. Because margins ranged from five to ten percent of the value of the contracts, many unsophisticated investors were unable to bear the risk of substantial losses in futures trading.[205] The CFTC Chairman testified that low margins for futures increased the danger of excessive speculation, and he questioned whether lending institutions should be making loans to help borrowers meet commodity futures margins.[206] The Chairman of the Federal Reserve Board, Paul Volcker, testified that the low cost of participating in the futures markets was important to hedgers, but it also attracted unhealthy kinds of speculation, such as that exemplified by the Hunts.[207] Indeed, over one billion dollars in loans were made to the Hunts to finance their silver futures trading.[208] The Treasury Department also asserted that margin requirements protect customers by screening out investors whose lack of sophistication and resources make them unsuitable customers for stock index and other futures contracts.[209]

A congressional committee studying events in the silver market agreed with the chairman of the CFTC that a strong case could be made that in markets tilted toward speculation, margins should be higher.[210] A House report sug-

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203. SEC SILVER REPORT, *supra* note 198, at 10-11.

204. *Hearings on Silver Prices*, *supra* note 201, at 34 (statement of Harold M. Williams).

205. *Id.* at 86-87.

206. *Id.* at 100.

207. *Id.* at 211.

208. *Id.* at 238, 242-44. A House report stated that Hunt related silver debts totaled approximately $1.8 billion and that the Hunts' bank loans during the latter part of 1979 were slightly in excess of $300 million. H.R. REP. NO. 395, *supra* note 201, at 145 (analyzes reasons for 1981 silver market collapse and ability of federal agencies to prevent recurrence).

209. *Hearings on Silver Prices*, *supra* note 201, at 407-08. The CFTC has rejected suitability as beyond its regulatory scheme. *See* Puckett v. Rufenacht Bromagen & Hertz, Inc., 903 F.2d 1014, 1020 (5th Cir.) (based on previous CFTC decision, broker has no duty to determine suitability of client for commodity futures trading), *reh'g denied* (Jun. 25), *quest. certified*, 919 F.2d 992 (5th Cir. 1990). *See generally* N. WOLFSON, R. PHILLIPS, & T. RUSSO, REGULATION OF BROKERS, DEALERS AND SECURITIES MARKETS ¶ 2.08[2] (1977) (describes suitability doctrine under federal securities laws).

210. *Silver Prices and the Adequacy of Federal Actions in the Marketplace, 1979-80: Hearings Before A Subcomm. of the House Comm. on Government Operations*, 96th Cong., 2d Sess. 103 (1980). The Chairman of the CFTC had testified that:

> Low speculative margins are probably the single strongest inducement to widespread non-commercial use of futures markets. Traditionally, the exchanges have set speculative margins low, often about five percent of the value of the contract. Thus, a very low threshold stands between the speculator with limited cash and the commodities markets. In the

gested that margins were so low that they could "encourage so much speculation on price movements that the commodity's price or availability is distorted, impeding commercial use of the market, and casting doubt on the contract's economic purpose."[211] Low margins on interest rate futures contracts based on U.S. Treasury Bills and U.S. Treasury Bonds were of particular concern because speculators held seventy to eighty percent of the open interests in these futures contracts.[212] The House report additionally suggested that, while margins generally were perceived as a way of guaranteeing performance, there were broader policies that should underlie margin authority, because futures margins "affect credit allocation, capital investment, and inflationary momentum, thereby affecting the nation's financial market policies."[213]

Intertwined with the silver crisis was another issue that had arisen in the futures markets as result of an innovation in futures trading - the creation of stock index futures contracts. In a 1980 letter to the CFTC, the Chicago Board of Trade advised that the Federal Reserve Board intended to promulgate margin requirements for stock index futures contracts once trading in such contracts was approved by the CFTC.[214] Later, in July, 1981, the SEC also contended that the Federal Reserve Board should have margin authority over options and futures on exempt securities and stock indices for corporate securities. Legislation authorizing this was introduced in Congress. One bill would have given the CFTC standby authority to set margins for limited periods of time. Another bill would have allowed the Federal Reserve Board to set margins on financial instruments and loans used to finance the purchase of financial instruments in either the cash or futures markets. A former chairman of the CFTC had also

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> silver market, for example, prior to September of last year, margins were generally lower than 5 percent. Accordingly, when silver was selling at roughly $10 an ounce, the margin requirement was only 30 cents an ounce. Each time the price rose another 30 cents, the value of the speculator's initial investment was doubled. No wonder there was a bubble mentality.
>
> If margins are to be used as a tool to prevent excessive speculation, the authority to set them must reside with government. The exchanges and commission houses will set margins high enough to protect themselves, but it is unlikely that they will regularly set them higher than their narrow financial interests demands. Surely they will not set them high enough to curtail their own business - and this is exactly what is required . . . .

Senate Silver Price Volatility Hearings, *supra* note 127, at 7.

211. H.R. REP. No. 395, *supra* note 201, at 121 (analyzes reasons for 1981 collapse of silver market and suggests that low margins may encourage speculation).

212. *Id.* at 123. In addition, there was concern that low margin requirements might tempt banks to speculate in the futures market since the FDIC protects their deposits. *Id.* at 124. Moreover, pyramiding could be used to build positions from unrealized profits paid out on futures contracts. *Id.* at 126 n.260.

213. *Id.* at 126-28.

214. *Senate Silver Price Volatility Hearings*, *supra* note 127, at 379, 382 (letter from Robert K. Wilmorth, Chairman of the Chicago Board of Trade to James S. Stone, Chairman of the Commodities Futures Trading Commission). The issue arose because the Kansas City Board of Trade had proposed the then unique concept of trading futures contracts on stock indices. *Id.* at 363. That concept was mimicked later by other exchanges and today stock index futures contracts are an important component of the futures industry. *See infra* notes 433-39 and accompanying text for a discussion of the role of these contracts in the stock market crash of 1987.

suggested that the CFTC should be allowed to set margin floors.[215]

These efforts met a storm of opposition by the opponents of federal margin authority. One CFTC commissioner argued that there was a simple distinction between commodity futures and securities margin: when futures contracts are purchased, no credit is extended, but when securities are purchased on margin, credit is extended.[216] He stated that, historically, high margin levels maintained over an extended period had not been an effective price control measure. The commissioner reiterated the argument that higher margins mean higher costs for hedgers that are in turn passed on to consumers. Additionally, higher margins could be inflationary. The CFTC commissioner drew further support from economists, who had stated that the imposition of higher margin requirements would not have made any difference in the recent silver situation. There, the exchanges had raised margins to very high levels; some brokerage firms even raised margins faster and higher than the exchanges. The result was that participation in the market dropped, but prices continued to increase, becoming more volatile as the market thinned.[217] The President of the Chicago Board of Trade believed that a centralized government agency simply could not set margins effectively.[218]

The exchanges once again argued that there was a delicate balance to be struck by experienced market professionals in setting margins, and that such a balance could not be achieved by a centralized government agency. The exchanges repeated that economists generally agreed that increasing margins was not an effective means of curbing volatile prices or preventing market manipulation.[219] Industry witnesses also pointed out that one silver futures exchange had altered margin requirements during the silver crisis eleven times between January, 1979 and early 1980.[220] It had set margin requirements as high as $75,000 a contract and as low as $2,000 a contract.[221] Some margins were as high as ninety percent of the value of the futures contracts being traded.[222]

A brokerage firm official also testified in Congress that commodity futures contracts are short lived inherently; their lives are simply too brief for a federal agency to impose margin changes.[223] Therefore, the only course for a federal agency charged with margin responsibilities would be to impose high, restrictive margin levels that would meet any conceivable situation, although "such a standard would preclude any meaningful trading interest in the commodity market and they will cease to exist or at the very least become so illiquid as to lose their

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215. H. R. REP. No. 395, *supra* note 201, at 128-29.

216. *Senate Silver Price Volatility Hearings*, *supra* note 127, at 45.

217. *Id.* at 46.

218. *Id.* at 252-53.

219. *Id.* at 82. Various economists testified in the congressional hearings that the efficiency of the futures markets are dependent upon the lowest possible margins. They also asserted that increasing margin requirements would raise the cost of marketing products, and that the federal agencies would not have the wherewithal to set margin requirements. *Id.* at 357-59, 582-84.

220. *Id.* at 99.

221. *Id.*

222. *Id.*

223. *Id.* at 247.

economic usefulness."[224]

The exchanges were not impressed by the Federal Reserve Board's expressed concern about the possibility of inequality of margins between the markets absent federal margin controls. Nor were they moved by the potential for erosion of the Federal Reserve Board's margin requirements for securities credit.[225] Although the Board had asserted that it had authority to adopt margin requirements for index futures products,[226] the Chicago Board of Trade questioned whether the Federal Reserve Board had power to adopt margin requirements for securities options traded on securities exchanges.[227] Another exchange noted that the only credit aspect of a futures transaction occurred when a bank lent money to finance delivery under the futures contract.[228] It asserted that Federal Reserve Board regulation of this type of credit extension might be appropriate but should be directed at lending institutions and not at the commodity futures exchanges.[229] It further noted that the Federal Reserve Board had not changed margin requirements for securities in over five years, while during the silver crisis margin requirements were changed frequently to keep up with changes in prices of silver.[230] Nevertheless, although the exchanges and at least one CFTC commissioner opposed federal margin control,[231] Congress determined to allow the CFTC to impose margin requirements in the event of a

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224. *Id.* The Chicago Board of Trade pointed out that Congress had previously refused to grant federal regulatory authority over margins, and it noted that the *Nathan Study*, had concluded that margins were not helpful in controlling prices. *Id.* at 330-38. *See supra* notes 136-41 and accompanying text for a discussion of the *Nathan Study*.

225. *Senate Silver Price Volatility Hearings*, *supra* note 127, at 381-83. *See also Hearings on Silver Prices*, *supra* note 201, at 125 (if exchanges set own rates margins may decrease through competitive pressures).

226. *Senate Silver Price Volatility Hearings*, *supra* note 127, at 381-82.

227. *Id.* at 385-86. The Seventh Circuit also later held that it simply was fortuitous that the security laws had any application to options. Board of Trade v. SEC, 677 F.2d 1137 (7th Cir.), *vacated as moot*, 459 U.S. 1026 (1982). Had the options exchanges been founded only one or two years later, regulatory authority over those exchanges would have fallen within the CFTC's ambit, instead of the Securities Exchange Act of 1934, which sets forth the Board's authority to set margins in 15 U.S.C. § 78(g). *Id.* at 1140 n.2.

228. *Senate Silver Price Volatility Hearings*, *supra* note 127, at 417-18.

229. *Id.* The Chicago Board of Trade position was that:

> [T]he purchase of sale of a futures contract is not a credit transaction. Such a contract merely entitles the owner to elect whether to receive or deliver commodities at a future date. If he elects to take delivery of the commodity, then, and only then, can he use the capital asset - the commodity which is conveyed at the time of the delivery. It is only at delivery that payment is made. Since no title is passed prior to delivery and no loan is extended, no credit can possibly be involved in a futures transaction. Thus the word 'margin' has an entirely different meaning in the futures markets than in the securities markets.

Id. at 330-31, 333-35, 338.

230. *Id.* at 418. A commodity exchange noted that Congress had considered legislation dealing with commodity futures contracts at least ten times since 1948 but had not adopted any such legislation. *Id.* at 424.

231. *Silver Prices and the Adequacy of Federal Actions in the Marketplace, 1979-80: Hearings Before A Subcomm. of the House Comm. on Government Operations*, 96th Cong. 2d Sess. 46, 82 (1980). *But see id.* at 103 (CFTC and SEC chairmen argue CFTC should control margins to regulate speculation).

market emergency.[232]

The controversy surfaced again when the CFTC's jurisdiction over stock index futures contracts was challenged in 1982.[233] At that time, the Federal Reserve Board advised Congress that clarification of the authority of the Board to set margins on equity-related instruments would be helpful in avoiding litigation.[234] The Board was concerned because of objections raised by the CFTC and the exchanges to the Federal Reserve Board's assertion that it had authority to regulate margins in stock index futures contracts.[235]

The Federal Reserve Board advised Congress that it had not mandated a margin level for futures on stock indexes because the exchanges had agreed to keep their margins at reasonable levels. Nevertheless, the Board had taken steps to develop a regulatory framework for potential future action.[236] The Board stated that, while it had decided not to adopt margin requirements for commodity futures contracts, such requirements might be appropriate later to limit the use of speculative credit and to assure competitive equality with stock options. Consequently, it would monitor the development of the market closely.[237] The Federal Reserve Board also announced a proposed rulemaking on margin for index futures contracts. It asked for comments on appropriate levels of margin and on the appropriate definitions for hedging transactions, as well as comments

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232. *See* Futures Trading Act of 1982, Pub. L. No. 97-444, § 225, 96 Stat. 2315 (codified as amended at 7 U.S.C. § 12a(9)) (amendment allows CFTC to direct contract markets to take action CFTC believes necessary to maintain or restore orderly trading in, or liquidation of, futures contract in event of market emergency). *See also* 17 C.F.R. § 1.41 (CFTC rule governing declaration of market emergency and promulgation of emergency rules). Previously, the CFTC appears to have interpreted this authority as allowing it to set margins in an emergency, even though statutory provisions did not confer that specific authority. *See* H.R. REP. NO. 395, *supra* note 201, at 127 (effectiveness of CFTC emergency margin requirements powers considered). For example, in 1976, a large default occurred in Maine potato futures contracts traded on the New York Mercantile Exchange. *Id.* In response to that emergency, the CFTC had ordered the exchange to increase margins for the futures contract to 100%. *Id.* (effectiveness of CFTC margin requirements in emergency considered); H.R. REP. NO. 1181, 95th Cong., 2d Sess. 98-99 (1978) (CFTC enabling legislation should be revised to strengthen emergency powers).

233. H.R. REP. NO. 565, pt. 2, 97th Cong., 2d Sess. 19 (1982); H.R. REP. NO. 626, pt. 2, 97th Cong., 2d Sess. 3 (1982).

234. *SEC/CFTC Jurisdictional Issues*, *supra* note 14, at 317. The Federal Reserve Board stated that it believed it had a right to exercise jurisdiction over margins on stock index futures. It did not, however, determine to exercise that purported jurisdiction. *Stock Index Futures Set; Fed Backs Off*, Wash. Post, Feb. 18, 1982, at D9, col. 1 (Federal Reserve Board avoids confrontation with CFTC by acquiescing to sales of stock index futures contracts). *See also U.S. General Accounting Office, Financial Markets: Preliminary Observations on the October 1987 Crash* 4 (1988) (SEC and CFTC must agree on how they will work together).

235. *See SEC/CFTC Jurisdictional Issues*, *supra* note 14, at 386.

236. *Id.* at 316-17; *see also Proposed Margin Requirements of Futures Contracts Based on Stock Indexes, Board of Governors of the Federal Reserve System* [1980-1982 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 21,353 (Feb. 25, 1982) (proposed margin requirements limit use of speculative credit and assure competitive equality among functionally similar market instruments).

237. *Commodity Futures Trading Commission Oversight, Hearing Before the Subcomm. on Commerce, Consumer, and Monetary Affairs of the House Comm. on Government Operations*, 97th Cong., 2d Sess. 192 (1982) [hereinafter *1982 Government Operations Hearings*] (Government Accounting Office Study of CFTC regulatory programs reviewed).

on other issues.[238] The Board stated that its purpose was to design a regulatory framework that would create the fewest operational problems.[239] It also maintained that it would adhere to its position that it had the power to impose margin requirements on index futures contracts. The Board further stated that it could not rule out imposing margin requirements on proposed corporate bond futures contracts.[240]

The Federal Reserve Board was supported aggressively by Benjamin S. Rosenthal, Chairman of the House Commerce Consumer and Monetary Affairs Committee. He stated that public policy with respect to credit allocation, capital investment, and inflationary concerns "should outweigh history or forum, and margin regulation on stock index futures should be set by the same agency and in pursuit of the same public objectives as margin regulation of equity in debt and securities."[241] Chairman Rosenthal argued that, as long as a speculator has unrestricted right to take delivery, then commodity futures margins will function as a down payment, rather than simply as a bond or guarantee of performance, as traditionally argued by the exchanges.[242] The CFTC responded that the development of stock index futures contracts and low margin requirements would not attract an increased number of small speculators to the futures market.[243] The chairman of the CFTC noted that individuals trading futures contracts comprise less than one percent of the stockholder population and that maintenance margin requirements might become onerous and discourage people from entering the market.[244] The CFTC chairman responded to an argument that there should be a level playing field for stock and futures margins by stating that requiring higher futures margins in fact could be more onerous than mandating an equal level of securities margins. This is because the purchaser of a futures contract is making a down payment for something he does not own.[245]

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238. *Id.*

239. *Id.* at 195.

240. *Id.* at 187. The Federal Reserve Board had previously advised the CFTC, in a comment letter concerning a proposed stock index futures contract with the Kansas City Board of Trade, that it had authority to regulate stock index futures contracts. *Id.* at 270. The CFTC did not believe that the Federal Reserve Board had such authority. *Id.* at 356. The CFTC stated that futures contract margins were not an extension of credit and there was a provision in the Commodity Exchange Act granting the CFTC exclusive jurisdiction over commodity futures contracts. *Id.* at 356-57. *See also* 7 U.S.C. § 2 (CFTC granted exclusive jurisdiction over commodity contracts for future delivery).

241. *1982 Government Operations Hearings*, *supra* note 237, at 187.

242. *Id.* In response to Congressman Rosenthal's concerns, the Federal Reserve Board advised him that it had written to the CFTC to express the Board's view that it had authority to establish margins in stock index futures contracts. *Id.* at 191.

243. *Id.* at 86-87.

244. *SEC/CFTC Jurisdictional Issues*, *supra*, note 14, at 86-87. *See also Securities/Commodities Accord Amendments of 1982, Hearings Before the Subcomm. on Securities by the Senate Comm. on Banking, Housing and Urban Affairs on S.2260*, 97th Cong., 2d Sess. 50-63 (1982) (CFTC chairman notes public speculators account for approximately 25% of all trading; remainder done by professionals and hedgers; well capitalized traders tend to be largest consistent market participants).

245. *SEC/CFTC Jurisdictional Issues*, *supra* note 14, at 90. The chairman stated that increases in margin requirements during the silver crisis, to levels as high as $70,000, had a major effect on market activity. *Id.* at 235.

The chairman further contended that increased margins would result in increased cost to hedgers, thereby potentially impairing the utility of the markets.[246] The chairman noted that the Securities Investor Protection Corporation ("SIPC") had paid out about $110,000,000 to reimburse customers' securities losses, causing higher transaction fees in the securities markets. These had been passed onto securities investors. The chairman also noted there had been for fewer failures in the commodities markets than in the securities markets, apparently suggesting that futures margins are most efficient in preventing losses and reducing transaction costs.[247] In fact, there is no SIPC insurance for commodity futures traders. Therefore, the commodity futures industry operates more efficiently than the securities industry, without a greatly disparate danger to customers and at less government expense. The CFTC additionally argued that there was no evidence that the futures exchanges were reluctant to raise margins for competitive reasons. It also noted the differences between margins for securities and futures.[248] Lastly, an economist argued that existing evidence suggested that there was no need to transfer authority for setting margin levels in futures contracts to the government.[249]

As a result of this opposition, no legislation giving any federal agency authority to regulate margins was adopted in 1982. Moreover, the SEC fared badly in a related court battle with the CFTC. In *Board of Trade v. SEC*,[250] the Seventh Circuit held that the SEC did not have authority to authorize options on GNMA securities contracts on the Chicago Board Options Exchange. Such jurisdiction was within the exclusive province of the CFTC.[251] The chairmen of the CFTC and SEC, however, signed the Shad-Johnson Accords, in which the two agencies agreed to allocate jurisdiction over option contracts between themselves.[252] That agreement essentially was codified in 1982,[253] but did not establish federal regulatory authority over margins on commodity futures contracts. Nor did the agreement end either the jurisdictional battles between the SEC and the CFTC, or the efforts to obtain federal control over margins.[254]

246. *Id.*

247. *Id.* at 249. Recently, a futures commission merchant in Chicago declared bankruptcy. The exchanges stepped in to pay customer losses of some $2 million. The vast majority of customer funds were already returned. *Stotler Claims Guaranteed by 2 Chicago Exchanges*, Wall St. J., March 27, 1981, at C17, col. 1 [hereinafter *Chicago Exchanges*].

248. *SEC/CFTC Jurisdictional Issues*, *supra* note 14, at 258-60.

249. *Id.* at 617-20.

250. Board of Trade v. SEC, 677 F.2d 1137, 1152-53 (7th Cir.), *vacated as moot*, 459 U.S. 1026 (1982).

251. *Id.* (CFTC has exclusive jurisdiction over options on GNMA securities).

252. *Joint Explanatory Statement of the Securities Exchange Commission and the Commodity Futures Exchange Commission* [1980-1982 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 21,332 (1982) (legislation proposed by SEC and CFTC clarifies jurisdictional boundaries regarding options on physical commodities and futures contracts on securities).

253. Securities and Exchange Commission Jurisdiction, Pub. L. No. 97-303, 96 Stat. 1410 (codified at 15 U.S.C. §§ 78-78(lll) (SEC and CFTC jurisdiction clarified).

254. *See id.*, *reprinted in* 1982 U.S. CODE CONG. & ADMIN. NEWS 1409.

I. Federal Reserve Board Review of the Need for Margin Controls

In 1982, during congressional hearings on the regulatory turf battle between the CFTC and SEC, the Federal Reserve Board announced that it was reassessing federal margin regulations because of the development of new financial futures and off-exchange instruments.[255] That study, the "Reserve Board Study," was not completed until December of 1984.[256] In a letter to Senator Jesse Helms attached to the Study, Paul Volcker asserted that margin on financial futures contracts should be more closely aligned with its underlying securities base to ensure competitive equity and to obtain a consistent regulatory structure.[257] But Volcker suggested that, to equalize the markets, it might be better to lower margin requirements on the stock markets.[258] The Board had concluded there no longer was justification for maintaining securities margins at levels higher than necessary to protect brokers and other lenders from customer defaults, except in extraordinary circumstances.[259]

Volcker outlined the Board's recommendation that Congress should give serious consideration to adopting a new approach for margin regulation.[260] It suggested that authority for setting margins should be given to self-regulatory organizations, such as the New York Stock Exchange and the National Association of Securities Dealers, Inc. The latter governs trading in the over-the-counter markets.[261] Volcker indicated that the Board's view was that those organizations should be encouraged to coordinate their margin setting activities to maintain safety in the marketplace and to avoid "unreasonable and unnecessary competitive advantages."[262]

Volcker's letter stated the Board's view that this new system could be coordinated by a council of federal agencies whose responsibility mainly would be to monitor the actions of the self-regulatory organizations.[263] Such a council could have the power to veto margins, but prior approval of margin changes would not be required. Volcker suggested that the CFTC and SEC should be members of such a council and that a third agency should provide a tie-breaking vote. Volcker suggested that the Federal Reserve Board or the Treasury Department would be possible candidates to serve in that capacity.[264]

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255. RESERVE BOARD STUDY, *supra* note 30. The *Reserve Board Study* was transmitted to Congress with a cover letter from Paul A. Volcker, Chairman of the Federal Reserve Board, to Senator Jessie Helms, Chairman of the Committee on Agriculture, Nutrition, and Forestry. *See* Letter from Paul Volcker to Senator Jesse Helms (Jan. 11, 1985) [hereinafter Helms letter] (outlines contents, interprets findings, and sets forth conclusions of *Reserve Board Study*).

256. Helms Letter, *supra* note 255, at 4.

257. *Id.*

258. *Id.*

259. *Id.*

260. *Id.* at 4-5.

261. *Id.*

262. *Id.*

263. *Id.*

264. *Id.* at 5. The *Reserve Board Study* suggested that margin on stock related futures contracts fell within its jurisdiction, but it conceded that it had not tested this in court. RESERVE BOARD STUDY, *supra* note 30, at 4.

In response to the Reserve Board Study, the CFTC asserted that it did not have, and did not seek to have, direct supervision over the setting of margin levels on futures by the exchanges. It noted that over the past decade, Congress had reviewed the Commodity Exchange Act three times without making any change in the provision that specifically prohibits the CFTC from setting margin levels. The CFTC stated that the present "pay-as-you-go" system used by the exchanges "worked well and [was] efficient and appropriate to the economic function served by futures trading." The CFTC found no reason for federal intervention.[265] It also asserted that there was no showing of competitive disadvantages resulting from margin disparities between the securities markets and the futures markets.[266] The SEC, on the other hand, endorsed the Federal Reserve Board's conclusion that there should be comparable margin regulation over derivative products, "particularly futures and options on stock indexes."[267]

The Department of Treasury responded to the Reserve Board Study by stating that abolishing federal margin regulation altogether, or transferring its authority to the self-regulatory bodies, subject to SEC oversight, deserves serious consideration. The Treasury stated that "whether or not the objectives of Congress in creating a system of federal securities margin regulations were valid in 1934, there no longer appears to be a need for such regulation today."[268]

The Reserve Board Study did not, by any means, end the debate over federal margin controls of futures contracts.[269] But it seemed to signal a retreat from prior governmental positions that such control was needed to protect small investors and to prevent undue price volatility from forced liquidations.[270] In fact, the Reserve Board Study virtually adopted the position advocated by the

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265. Letter from Susan M. Phillips, Chairman, CFTC, to Paul A. Volcker, Chairman of the Board of Governors of the Federal Reserve (Nov. 16, 1984).

266. *Id.* at 7.

267. Letter from John S.R. Shad, SEC, to Paul A. Volcker, Chairman of the Board of Governors of the Federal Reserve (Jan. 3, 1985).

268. Letter from Donald T. Regan, Secretary of the Treasury, to Paul A. Volcker, Chairman of the Board of Governors of the Federal Reserve (Dec. 6, 1984). The Secretary of Treasury's letter also noted that, on December 22, 1983, a Vice Presidential task group had proposed that federal margin regulations be eliminated, or at least confined to emergency situations. *Id.*

269. *See generally Improving the Efficiency of the Commodity Futures Markets, Hearing Before the Joint Economic Comm.*, 98th Cong., 2d Sess. 60-61 (1984) (suggestion that margin requirements be raised to limit speculation met with argument that such controls could impair futures markets, thus no legislation adopted). *See infra* notes 433-39 and accompanying text for a discussion of renewed concerns over federal margin control due to the 1987 stock market crash.

270. The Federal Reserve Board's retreat may also reflect a greater familiarity with the futures markets and an understanding of the role that futures play in the financial system. As directed by Congress in 1982, the Treasury Department, the Federal Reserve Board, and the CFTC conducted a study of financial futures contracts. CFTC, FEDERAL RESERVE BOARD, & SEC, A STUDY OF THE EFFECTS ON THE ECONOMY OF TRADING IN FUTURES AND OPTIONS I-2 (1984) [hereinafter EFFECTS OF FUTURES AND OPTIONS] (discusses purpose and effects of futures and options trading and adequacy of current regulation). The study found bona fide uses for futures contracts, and it did not find evidence that futures trading results in significant harm to public customers or to derivative or related cash markets. *Id.* Nevertheless, a potential for such harm was found. *Id. See generally* II L. LOSS & J. SELIGMAN, SECURITIES REGULATION 1079-80 (3d ed. 1989) [hereinafter LOSS & SE-

commodity exchanges — that is, the only purpose of margin should be the protection of the financial integrity of the exchanges and their members. The Study, however, diverged from the exchanges' positions by recommending that the government play a residual oversight role to assure overall market integrity and to eliminate intermarket competition through reduced margin rates.[271]

II. Regulatory Efforts Under the Federal Securities Laws

A. *Early Efforts to Impose Controls*

Margin requirements for securities have been a part of the financial system of the United States for over 150 years.[272] Like futures margins, early stock exchange margin rules were for the protection of the broker, not for the purpose of dissuading customers from entering the market or engaging in excessive speculation.[273]

Minimum margin requirements initially imposed by the securities exchanges were simply gentlemen's agreements.[274] After the panic of 1907, however, New York Governor Charles Evans Hughes appointed a committee to investigate securities and commodities trading.[275] The Hughes Committee suggested that the New York Stock Exchange ("NYSE") member firms should require a minimum margin of twenty percent.[276] Thereafter, the "Pujo Committee," which held extensive hearings in 1912 to investigate the so-called "Money Trust," recommended legislation to require minimum securities margins of twenty percent, and it recommended other restrictions on margin trading.[277] As a result, the New York Stock Exchange adopted a margin rule in 1913 that required "proper and adequate margin."[278] This did not, however, forestall legislation. The Federal Reserve Act, enacted in 1913, prohibited member banks from discounting credit drawn to post margin for securities.[279] This restriction was intended to make security margin loans a less desirable banking

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LIGMAN] (study concludes that futures and options markets shift economic risks, have no negative influence on capital formation, and thus do not require additional federal regulation).

271. Helms Letter, *supra* note 255, at 4-5.

272. *Stock Exchange Regulation*, *supra* note 58, at 511. Two authors have traced the use of securities margin trading to 1791, when loans were secured by government bonds. J. BOGEN & H. KROOSS, SECURITY CREDIT: ITS ECONOMIC ROLE IN REGULATION 2-3 (1960) [hereinafter BOGEN & KROOSS].

273. *Stock Exchange Practices*, *supra* note 58, at 6475. At the turn of the century, most brokerage firms would do business on a ten percent margin. RESERVE BOARD STUDY, *supra* note 30, at 85.

274. RESERVE BOARD STUDY, *supra* note 30, at 85.

275. *Id.* at 86.

276. *Id.* at 85. A National Monetary Commission Study "concluded that securities credit had played a role in all major financial crises from 1873 to 1907." *Id.* at 44 (quoting Sprague, *History of Crises under the National Banking System* in PUBLICATIONS OF THE NATIONAL MONETARY COMMISSION, THE NATIONAL BANKING SYSTEM 5 (1916)).

277. RESERVE BOARD STUDY, *supra* note 30, at 44-45. The objectives of the Pujo Committee and the Hughes Committee "were to curb speculation based on margin in order to protect market participants from their own greed and to promote greater stability of security prices." *Id.* at 86.

278. *Id.* at 45.

279. *Id.* at 44.

practice and to prevent Federal Reserve credit from being used to expand margin trading.[280]

Concerns about margin trading in the securities industry grew during World War I, but for the opposite reason. Efforts were undertaken by the Federal Reserve Board and New York City banks at that time to assure sufficient money was available for securities lending purposes.[281] After the war, however, as interest in stock trading increased, the "money committee" that was set up to monitor securities lending sought to restrict the amount of loans.[282] "Moral suasion" was used in 1919 as a means to curb excessive use of margin credit.[283] These efforts were later discontinued because of concerns that they were limiting the buying power of the market.[284]

In 1926, as the market boom began to reach full steam, the Federal Reserve Board sought to limit speculative margin trading. It published weekly data on loans to brokers by New York City banks "in the hope that publication of the statistics would help restrain expansion of such credit."[285] The Federal Reserve Board similarly sought to limit margin loans during the 1928-1929 market upsurge, though those efforts proved unsuccessful.[286]

After the Stock Market Crash of 1929, banking legislation that authorized the Federal Reserve Board to restrict the supply of funds for security margin loans by banks was enacted.[287] The statute limited the percentage of member banks' capital and surplus that could be used for margin loans.[288] The Federal Reserve Board also was authorized to suspend borrowing privileges for member banks engaged in making excessive margin loans.[289] These provisions, however,

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280. BOGEN & KROOSS, *supra* note 272, at 76.

281. *Id.* at 77.

282. *Id.* at 77-78.

283. SEC, REPORT OF SPECIAL STUDY OF SECURITIES MARKETS OF THE SECURITIES AND EXCHANGE COMMISSION H.R. DOC. NO. 95, 88th Cong., 1st Sess., ch. 10, at 2 (1963) [hereinafter SPECIAL STUDY].

284. BOGEN & KROOSS, *supra* note 272, at 78-79. By 1922, most exchange members were requiring margins equivalent to about seventeen percent, RESERVE BOARD STUDY, *supra* note 30, at 45. This increased to about twenty-two percent in 1929 and to twenty-five percent in 1933. *Id.*

285. BOGEN AND KROOSS, *supra*, note 272, at 79; SPECIAL STUDY, *supra*, note 283, ch. 10, at 2.

286. SPECIAL STUDY, *supra* note 283, ch. 10, at 2. The New York Stock Exchange also raised its minimum margin requirements to about 25%. RESERVE BOARD STUDY, *supra* note 30, at 86. Previously, there had been an unwritten rule that 20% margin was sufficient. *Id.* at 86-87. Brokerage firms were imposing on customers their own margin requirements as high as 50% or more. *Id.* at 86-88 (quoting R.W. SCHABACKER, STOCK MARKET THEORY AND PRACTICE 153 (1930)).

287. Act of June 16, 1933, § 3(a), 48 Stat. 163 (1933) (codified as amended at 12 U.S.C. 301) (federal reserve banks required to ascertain whether there was undue use of bank credit for speculative trading; member banks were to report speculative lending to Federal Reserve Board, which could suspend member bank from use of Federal Reserve credit facilities). *See also* Banking Act of 1933, § 7, 48 Stat. 167 (1933) (codified as amended at 12 U.S.C. § 248(m)) (Federal Reserve Board required to provide safer use of assets to prevent undue diversion of funds for speculative operations). In addition, the amount of money loaned for stock purchases could not exceed some percentage, set by the Federal Reserve Board, of all loans made by banks. 2 L. LOSS, *supra* note 123, at 1241 n.6.

288. 12 U.S.C. § 248(m) (banks limited to 10% of capital and surplus for margin loans).

289. BOGEN & KROOSS, *supra* note 272, at 81. 2 L. LOSS, *supra* note 123, at 1241-42.

never were used because of the subsequent enactment of the Securities Exchange Act of 1934.[290]

B. The Securities Exchange Act of 1934 and Margin Controls on Securities

The margin control provisions of the Securities Exchange Act of 1934 were the direct, albeit somewhat delayed, result of the stock market crash of 1929.[291] Although bills to control margin trading had been introduced in Congress as early as 1930, they failed to gain legislative approval.[292] Then, in 1932, the Senate Banking and Currency Committee conducted an investigation into the securities markets.[293] That investigation, spearheaded by Ferdinand Pecora, received widespread publicity, as did his view that "margin trading should be restricted or eliminated."[294] In addition, the democratic party platform of 1932 called for the regulation of securities credit, and Franklin Roosevelt made the issue part of his campaign.[295]

After Roosevelt's election, the Secretary of Commerce formed a committee, chaired by Assistant Secretary of Commerce John Dickinson, to report on appropriate regulation for securities exchanges.[296] The report, issued on January 27, 1934, concluded that "[n]o attempt to deal with the abuses of stock exchange operations can omit the subject of margin trading. . . ."[297] It recommended that margin trading be restricted to curb excessive speculation, and that a federal stock exchange authority be created to require margin transactions to be conducted only on specified, minimum levels.[298]

After extensive hearings, the Senate Committee on Banking and Currency concluded that legislation was needed to control margin trading and other abuses that had "stimulated security values to unsound levels from which they have inevitably receded with disastrous consequences to the whole national

290. BOGEN & KROOSS, *supra* note 272, at 82; 2 L. LOSS, *supra* note 123, at 1242 n.6; RESERVE BOARD STUDY, *supra* note 30, at 45.

291. *See* 15 U.S.C. 78(g) (rules and regulations for the extension of credit). For a discussion of the stock market crash of 1929. *See generally*, J. GAILBRAITH, THE GREAT CRASH: 1929 (1979); W. KLINGAMAN, 1929, THE YEAR OF THE GREAT CRASH (1989); G. THOMAS & M. MORGAN-WITTS, THE DAY THE BUBBLE BURST (1979).

292. BOGEN & KROOSS, *supra* note 272, at 85-86.

293. *Id.* at 86.

294. *Id.* at 88.

295. *Id.* at 86.

296. *Id.* at 86-87.

297. *Id.* at 87. *See* Sullivan, *Application of Margin Rules To Tender Offers By Foreign Investors*, 8 N.C.J. INT'L L. & COM. REG. 17 (1982) (discusses how margin trading conducted in securities industry).

298. BOGEN & KROOSS, *supra* note 272, at 87. The Twentieth Century Fund also published a report on reforms needed in the securities market. It stated that:

> The problem of the control of speculation is essentially the problem of the control of margin buying. It is the use of credit to finance the purchase of securities that makes possible such rampant bull markets as that of 1928-29. It is the use of credit that forms the most direct and intimate tie between the security markets and banking and business. Security speculation in the absence of credit would assume a vastly different character.

TWENTIETH CENTURY FUND, INC., STOCK MARKET CONTROL 177-178 (1934).

economy."[299] It concluded that the "lending of money to brokers or upon securities in connection with margin transactions is one of the great problems in the banking structure."[300] Of particular concern was excessive speculation — speculation that "stimulates and exaggerates the normal swing of economic tendencies."[301] Excessive speculation could be curbed through the restriction of margin trading.[302]

Unlike the Agricultural Committees, the Senate Committee on Banking and Currency viewed margin as a prime culprit in the speculative boom that led to the depression.[303] It found that, through margin trading, "a great many people [had] been induced to embark upon speculative ventures in which they were doomed to certain loss."[304] Moreover, during the boom in the 1920's "a vast and unhealthy volume of credit was sucked into the securities markets to the deprivation of agriculture, commerce and industry, which made possible the inflation of prices of securities out of all proportion to their value."[305] "Feverish speculation accelerated the process of inflation until the bubble burst in October 1929."[306] When the stock market crashed, brokers' loans were called and this

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299. STOCK EXCHANGE REGULATION, LETTER FROM THE PRESIDENT OF THE UNITED STATES TO THE CHAIRMAN OF THE COMM. ON BANKING AND CURRENCY WITH AN ACCOMPANYING REPORT RELATIVE TO STOCK EXCHANGE REGULATION, 73d Cong., 2d Sess. 3 (Comm. print 1934) [hereinafter LETTER FROM THE PRESIDENT].

300. *Id.* at 11.

301. *Id.* at 15.

302. *Id.* at 16.

303. S. REP. NO. 792, 73d Cong., 2d Sess. 3 (1934); S. REP. NO. 1455, 73d Cong., 2d Sess. 9 (1934). Congress apparently did not make any serious comparison of regulatory difference in the securities industry and commodity futures industries. During the debates on the Securities Exchange Act of 1934, however, there was a colloquy about margin requirements on the futures exchanges. One Congressman stated that Congress had been trying for years to resolve some of the evils on the commodities exchanges but that those problems had not yet been solved. 78 CONG. REC. 8393 (1934). In addition, one senator questioned whether stock price fluctuations could be limited by setting daily price limit fluctuations, as was done on the Grain Exchange in Chicago. STOCK EXCHANGE PRACTICES, *supra* note 58, at 6495. He was advised, however, that such "artificial limitations" would not be workable. *Id. See also* Helms Letter, *supra* note 255, at 2 (citing three objectives of SEC Act of 1934).

304. S. REP. NO. 792, 73d Cong., 2d Sess. 3 (1934). As stated in a Senate Report: "Excited by the vision of quick profits, they assumed margin positions which they had no adequate resources to protect, and when the storm broke they stood helplessly by while securities and savings were washed away in a flood of liquidation." S. REP. NO. 1455, *supra* note 303.

Congress found that credit was extended on margin loans without the personal credit of the borrower being examined. *Id.* Instead, creditworthiness was determined solely by the security, in the form of the stock being margined. *Id.*; *Stock Exchange Regulation*, *supra* note 58, at 577. Apparently, investors often did not know that they were subjecting themselves to additional liability through their margin loan agreement. Yet, if markets went down dramatically, the customer could be left with a large unexpected debt. STOCK EXCHANGE PRACTICES, *supra* note 58, at 6440.

305. S. REP. NO. 792, *supra* note 304. Margin requirements were thought necessary not only to protect traders purchasing on a thin margin with slim equity but also to protect the national business system from unwarranted stock price fluctuations. STOCK EXCHANGE PRACTICES, *supra* note 58, at 6494.

306. S. REP. NO. 792, *supra* note 304. Congress found that margin loans had become a major part of Wall Street's business. About 40% of the trading conducted on the New York Stock Exchange was on margin. 78 CONG. REC. 8390 (1934). Call loans formed the greatest portion of this

caused even greater depreciation in securities values.[307] A number of bank failures followed.[308]

The ready availability of loans for stock market margin transactions stimulated a rapid expansion, then contraction, of the total volume of credit, in response to swings in speculative enthusiasm. In addition, stock exchange trading on margin diverted credit from small industries throughout the country.[309] The speculative boom from 1927 to 1929 also attracted funds from abroad, resulting in a large accumulation of foreign balances.[310] When the market slumped and the depression started in the 1930's, these funds were withdrawn from the United States with debilitating effects.[311]

Representative Wolverton asserted in Congress that margin requirements were directly related to the level of speculation and that the amount of margin could create or curtail speculation: "No one denies it can be utilized either as an accelerator or a brake."[312] Margin credit made other credit enormously expensive in times of speculation.[313] Thomas Cocoran informed Congress that the very nature of margin trading encouraged pyramiding.[314] A Federal Reserve

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business, and the call money market had become a central money market for the United States because it was a market where banks could invest their surplus funds. *Stock Exchange Regulation*, *supra* note 58, at 56.

307. S. REP. NO. 792, *supra* note 304. Brokers who were members of the New York Stock Exchange had sometimes borrowed as much as 52 times their capital for margin purposes. *Stock Exchange Regulation*, *supra* note 58, at 91. Broker loans grew from a $1.5 billion to $8.5 billion dollars during the speculative period of the 1920s. *Id.* at 68-69. The latter "figure . . . takes on its properly impressive dimensions when compared to the entire national debt of the United States at that time: $16.9 billion." T.H. WATKINS, RIGHTEOUS PILGRIM 232 (1990).

When banks started calling broker loans, the prices of stocks begin to drop because the sales resulted in strong selling pressure. *Stock Exchange Regulation*, *supra* note 58, at 68-69. This in turn had a spiraling downward effect on the market. *Id.* As a result, margin loans created a "socially and economically dangerous situation" because as prices dropped and loans were liquidated, sales in securities were conducted on a vast scale. STOCK EXCHANGE PRACTICES, *supra* note 58, at 6441. This brought other securities "under water," and those securities were then also "dumped" on the markets, causing a further decline in prices. *Id.*

308. S. REP. NO. 792, *supra* note 304.

309. *Stock Exchange Regulation*, *supra* note 58, at 68. Representative Wolverton stated in Congress that:

> To finance these stock transactions, and to provide funds for new security issues, of every conceivable kind and character, increased interest and other inducements were made that had the effect of drawing into this whirlpool of speculation the funds of local banks from the remotest parts of our country. These funds would otherwise have been utilized in financing local enterprises. When the bubble burst, the harmful effects were consequently felt in every locality throughout the land. The innocent suffered with the guilty. The individual who had deposited his or her life's savings in a bank, a building-and- loan association, or a home, felt the effect and suffered the loss, although he had never purchased a share of stock on any exchange.

78 Cong. Rec. 7864 (1934).

310. *Stock Exchange Regulation*, *supra* note 58, at 68.

311. *Id.*

312. 78 Cong. Rec. 7865 (1934).

313. STOCK EXCHANGE PRACTICES, *supra* note 58, at 6442.

314. *Id.* at 6483-84. Mr. Corcoran stated in the hearings on the securities legislation that, in a

Board official advised Congress that securities margin "makes necessary rapid sales in the case of a rapid declining market, and therefore adds to the flexibility or the erratic character of the market."[315]

The Federal Reserve Board official further charged that the large volume of margin trading in the United States by small accounts made manipulation easier to complete.[316] A manipulator could bid up prices and thereby increase margins by small traders who would in turn pyramid their holdings on the basis of their margins. This increased prices further. Later, manipulators could depress the price of stocks and thereby deplete margins so that small traders would have to sell out. This would, in turn, push prices down further.[317]

The margin requirements sought by President Roosevelt met with strong opposition. Congress received a flood of opposing letters; it was rumored that about 1500 lobbyists had been sent to Washington to fight the legislation sought by the President.[318] Opponents of stock margin regulation asserted, like their brethren on the commodity exchanges, that margin controls should be left "as matters of self preservation to the exchanges themselves."[319] John Dickerson, the Assistant Secretary of Commerce, stated that control of margin trading should vary with economic conditions and that "liquidity as affected by margin requirements changes in importance from time to time, and it seems hardly desirable to freeze requirements into the provisions of a statute".[320]

The New York Stock Exchange additionally argued that the size of margin loans could not be determined by a single factor or percentage formula.[321] Rather, several things had to be considered, such as the market value, size and activity of the particular issue, the earnings on the issue, its distribution among investors, the volatility of the securities and the general condition of the market.[322] "These are the factors which reasonable men must consider in determining the amount of credit which can be advanced upon security collateral, and they cannot be reduced to a formula, according to the NYSE."[323]

The NYSE pointed out that during the stock market boom, brokers did raise their margin requirements.[324] In June 1929, the NYSE imposed a twenty-five percent margin requirement, and individual brokers were charging as high as fifty percent.[325] But speculation continued in increasing amounts.[326] During the October 1929 crash, brokers lowered their margin requirements because

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rising market, it is human nature for traders simply to pyramid their margin and buy "some more." *Id.* at 6484.

315. *Id.* at 6451.

316. *Id.* at 6456-57.

317. *Id.* at 6457.

318. 78 CONG. REC. 8097 (1934).

319. *Stock Exchange Regulation*, *supra* note 58, at 452.

320. *Id.* at 510.

321. STOCK EXCHANGE PRACTICES, *supra* note 58, at 7481.

322. *Id.*

323. *Id.* Margin affects liquidity by restricting speculation. To have an active market, speculators are required to provide liquidity. *Id.* at 6484.

324. *Id.* at 6709.

325. *Id.* at 6709-10; Furbush & Poulsen, *Harmonizing Margins: The Regulation of Margin*

they thought that this would mitigate the effects of additional margin calls.[327] It did not. In 1931, the New York Stock Exchange also reduced its minimum margin requirements to about twenty percent to stop price declines.[328] Nevertheless, the market continued to decline. It was asserted, therefore, that margins should not be branded as a culprit in the market boom and bust.[329]

Congress disagreed. Section 7 of the Securities Exchange Act of 1934 was enacted to authorize the Federal Reserve Board to establish minimum margin requirements for securities transactions.[330] Today, under Section 7, an initial extension of credit may not generally be more than fifty-five percent of the security's current market price.[331] Some securities, however, may have more favorable margin rates. For example, for Treasury Bills one may receive credit up to 90 percent of margin.[332] "This more highly leveraged transaction of Federal Government Notes is more in line with the margin requirements for the more speculative commodity markets."[333] The Securities Exchange Act does not require maintenance margin, but self-regulatory organizations, such as the New York Stock Exchange and the National Association of Securities Dealers, do impose such requirements.[334] These rules require the current market value of collateral to be at least twenty-five percent of the account's total value.[335]

Levels in Stock Index Futures Markets, 74 CORNELL L. REV. 873, 876 (1989) [hereinafter *Harmonizing Margins*].

326. *Harmonizing Margins*, *supra* note 325, at 876.

327. *Id.*

328. *Id.*

329. *Id.*

330. Securities Exchange Act of 1934, § 2, 48 Stat. 881 (1934) (codified as amended at 15 U.S.C. § 78g(a)). The Federal Reserve Board has adopted various regulations under this provision. Regulation T, for example, governs the extension of credit by broker-dealers on securities transactions. *Harmonizing Margins*, *supra* note 325, at 878-79. Regulation U regulates bank loans that are secured directly or indirectly by stock or margin securities. *Id.* Regulation G applies to other persons who make loans in which a security is used as collateral. *Id.* *See generally* 2 LOSS, *supra* note 123, at 1244. In addition, SEC Rule 10b-16 requires broker-dealers to disclose the cost of margin transactions to customers. 17 C.F.R 240.10b-16.

331. 15 U.S.C. § 78g(a).

332. T. HAZEN, THE LAW OF SECURITIES REGULATION 574 (1989).

333. *Id.* Hazen has also stated that "[o]ne way to achieve comparable leverage in the securities market is to trade listed 'put' and 'call' options. *Id.* at 574 n.8. *See also* Climan, *Civil Liability Under the Credit-Regulation Provision of the Securities Exchange Act of 1934*, 63 CORNELL L. REV. 206 (1978) (general discussion of securities margin).

334. T. HAZEN, *supra* note 332, at 574-75.

335. *Id.* at 575. The chairman of the CFTC has pointed out that there are federal securities laws exemptions that allow some traders to avoid the 50% level of margin imposed on most securities transactions. She stated that:

> In comparing margin-setting procedures in the securities and futures markets, it should be noted that while the Federal Reserve Board has margin-setting authority for securities and securities margins, it has established a substantial number of exemptions to the 50 percent margin requirement generally applicable to public customers, including exemptions for market-makers, arbitrageurs and other securities professionals. Under these exemptive provisions, only good faith margins fixed by negotiation between the lender and the borrowing customers, which are not subject to any specified minimum, are required. Moreover, the Federal Reserve Board has delegated authority to establish margin levels for

C. *Subsequent Events in the Securities Markets: The Federal Reserve Board Questions Whether Margins Are an Effective Regulatory Tool*

Since the adoption of the Securities Exchange Act of 1934, the Federal Reserve Board has changed its initial margin ratios about twenty-five times. Margin levels have ranged from a low of about forty percent in the late 1930s, to a high of 100 percent just after World War II.[336] Generally, the required minimum ratios have fluctuated between fifty and seventy percent.[337] The ratios were changed by the Federal Reserve Board as a result of events in the securities markets "such as relatively sharp movements in the amount of security credit outstanding or in the volume of trading activity — or in the economy."[338]

To cite an example, in November and December, 1954 securities "prices shot up abruptly, reaching heights equal to and even in excess of those on the eve of the 1929 crash."[339] The Federal Reserve Board raised margin rates.[340] John Kenneth Gailbraith argued, however, that the situation in 1954 was not comparable to that of 1929.[341] There was also testimony that debt for securities transactions had not increased significantly prior to the stock market boom in 1954.[342] Moreover, as the president of the New York Stock Exchange pointed out, twenty-eight percent of all securities listed on the stock exchanges were held by institutions.[343] This suggested that the nature of the market was changing

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> options on securities to the securities exchanges on which such options are traded. The levels of these margins were comparable to futures margins on October 19 [1987].

Legislative Recommendations Concerning the Stock Market Break of October 19, 1987, Hearing Before the Senate Comm. on Banking, Housing, and Urban Affairs, 100th Cong., 2d Sess. 133-34 (1988) [hereinafter *Legislative Recommendations*].

Extensions of time within which margin deposits can be made also may be sought from self-regulatory organizations. In 1975, an SEC report noted that the New York Stock Exchange received about 450,000 requests per year for such extensions and that it generally granted those extensions automatically. REPORT OF THE SPECIAL STUDY OF THE OPTIONS MARKETS TO THE SECURITIES AND EXCHANGE COMMISSION, PRINTED FOR THE HOUSE COMM. ON INTERSTATE AND FOREIGN COMMERCE, 96th Cong., 1st Sess. 496-97 (Comm. Print. 1979) [hereinafter SPECIAL STUDY OF THE OPTIONS MARKETS].

336. 2 L. LOSS, *supra* note 123, at 1245.

337. *Id.* at 1244-1248. Advocates for the complete elimination of margin trading remained. *See* K. SIMPSON, THE MARGIN TRADER 134 (1938) (securities trading should be conducted on cash basis).

338. RESERVE BOARD STUDY, *supra* note 30, at 48. In January of 1946, the Federal Reserve Board prohibited all margin transactions. It was claimed that this action was unauthorized because "the power to raise margin requirements was granted in order to prevent the diversion of credit from other uses to speculation, while the Board's action was taken at a time when there was no indication that ample credit was not available for all purposes." Note, *Regulation of Stock Market Manipulation*, 56 YALE L.J. 509, 511 n.10 (1947) (citations omitted).

339. *Stock Market Study, Hearings Before the Senate Comm. on Banking and Currency*, 84th Cong., 1st Sess. 1 (1955) [hereinafter *Stock Market Study*].

340. *Id.* at 41 (statement of J.W. Fulbright, Chairman, Comm. on Banking and Currency). Margin levels increased to 70% in 1955; decreased to 50% in 1957; increased to 90% in 1958; decreased to 70% in 1960. *See* 2 L. LOSS, *supra* note 125, at 1247-48.

341. *Stock Market Study*, *supra* note 339, at 288 (statement of John Kenneth Galbraith).

342. *Id.* at 553 (statement of W. Martin Jr., Chairman, Board of Governors, Federal Reserve Board).

343. *Id.* at 564 (statement of Sen. Lehman).

and that margin requirements were not needed to protect these large players because they have sufficient funds and expertise to protect themselves.

Later, in 1962, a special study of the securities industry was conducted by the SEC to determine, among other things, whether margin requirements were serving the purposes intended by Congress.[344] The study noted three reasons for the adoption of the margin control provisions of the Securities Exchange Act of 1934.[345] First, the provisions were intended to protect the "lamb," that is, a trader who had purchased stock on a thin margin and whose "slim equity [position] puts him at risk of total loss in the event of a price decline."[346] Second, margin control was intended to protect "the national business system from the fluctuations that are induced by fluctuations in the market, which in turn stem back to this very exquisite liquidity you get when you have a lot of borrowed money in the market."[347] Finally, a third purpose for margin control was to provide the government with the ability to reduce the aggregate amount of the country's credit resources that could be directed into speculation in the stock market and away from commerce and industry.[348] The study concluded, however, that it "is doubtful whether margin controls alone would accomplish what was hoped in 1934."[349]

The Special Study stated that the SEC's primary concern had been with "the efficacy of security credit controls in preventing speculative excesses that produce dangerously large and rapid securities price rises and accelerated declines in the prices of given securities issues and in the general price levels of securities."[350] When forced sales put pressures on securities prices, they may have a snowballing effect, which may affect the whole market.[351] But losses to a particular investor in a thinly margined securities account are not of serious significance from a regulatory point of view.[352] Instead, the Special Study was concerned with a chain reaction in which a series of margin calls would induce "waves of selling, each caused by the other, . . . with increasing rapidity and effect."[353] This decline could spread to other issues and affect investor psychology. It was thought that this phenomenon was a significant feature of the great crash of 1929.[354] The Special Study concluded that the margin provisions in

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344. SPECIAL STUDY, *supra* note 283.

345. *Id.* at 2.

346. *Id.* (quoting *Hearings Before a Senate Comm. on Banking and Currency*, pt. 15, 73d Cong., 1st Sess. 6494 (1934)).

347. *Id.*

348. *Id.* (quoting *House Committee on Interstate and Foreign Commerce*, H.R. REP. NO. 1383, 73d Cong., 2d Sess. 8 (1934)).

349. *Id.*

350. *Id.*

351. *Id.* The *Special Study* also noted the interrelationship between stock market volatility and market liquidity. *Id.* at 9. Liquidity is an important aspect of securities trading, but it can also lead to volatility, which can threaten the value of an asset held as collateral. *Id.* This is why there is a minimum maintenance requirement. *Id.* The *Special Study* stated that "volatility resulting from liquidity is more characteristic of securities than in most other kinds of financial assets." *Id.*

352. *Id.* at 11.

353. *Id.*

354. SPECIAL STUDY, *supra* note 283, at 11.

Section 7 of the Securities Exchange Act[355] "had a significantly moderating effect on the number of margin calls that went out during the market break of May, 1962, and may have been responsible for its not having been worse, either in depth or duration, than it was."[356] During the 1962 market break, margin calls were increased substantially, but there were only a relatively small number of forced liquidations.[357]

Following the Special Study, the SEC conducted a study of institutional investors.[358] The resulting report noted that by 1970, institutions held almost forty percent of equity securities.[359] Institutional holdings had increased from less than seven percent around the turn of the century to twenty-four percent in 1952, and to twenty-six percent by 1958.[360] The growth in institutional trading was fueled by, among other things, negotiated commissions.[361] The SEC also found that the securities markets were changing in rapid and significant ways because of the greatly increased volume of institutional trading and the technological and economic power that institutions brought to the market place.[362] Further, the Federal Reserve thought that a sharp rise in the stock market in the summer of 1968 was due to a speculative atmosphere, to which institutional investors were contributing.[363]

In 1979, the New York branch of the Federal Reserve Board conducted an extensive study to determine whether margin regulations were achieving the goals sought by Congress.[364] It found that the amount of credit used for speculation in the stock markets had dropped to below three percent of all credit extended by commercial banks.[365] Consequently, there was little basis for concern about diverting credit to the stock markets from other parts of the economy.[366] The study also found that changes in margin requirements may not reduce price fluctuations in the marketplace.[367]

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355. 15 U.S.C. 78g(a).

356. SPECIAL STUDY, *supra* note 283, at 11.

357. *Id.*

358. INSTITUTIONAL INVESTOR STUDY, REPORT OF THE SECURITIES AND EXCHANGE COMMISSION, H.R. DOC. No. 64, 92d Cong., 1st Sess., Vol. 1, at IX (1971) [hereinafter INSTITUTIONAL INVESTOR STUDY].

359. *Id.*

360. *Id.*

361. *Id.* at XXII. By 1986, institutional block sales constituted almost 50% of volume on the New York Stock Exchange, up from 15% in 1970. REPORT OF THE PRESIDENTIAL TASK FORCE ON MARKET MECHANISMS II-16 (1988) [hereinafter BRADY REPORT]. Today, institutional trading comprises a majority of the market. Institutional assets "grew from $2.1 trillion in 1981 to $5.2 trillion in 1988." U.S. CONGRESS OFFICE OF TECHNOLOGY ASSESSMENT, ELECTRONIC BULLS AND BEARS 32-33 (Sept. 1990) [hereinafter BULLS AND BEARS].

362. INSTITUTIONAL INVESTOR STUDY, *supra* note 358, at IX.

363. *Id.* at 4.

364. FEDERAL RESERVE BANK OF NEW YORK STAFF STUDY, SECURITIES CREDIT REGULATIONS OF THE BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM (1979) [hereinafter 1979 N.Y. FEDERAL RESERVE STUDY].

365. *Id.* at part 1, ch. II, at 25.

366. *Id.* at 28.

367. *Id.*; SECURITIES CREDIT REGULATIONS OF THE BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM: EXECUTIVE SUMMARY 7 (1979). It stated that:

Thereafter, the Federal Reserve Board conducted its own study of margins and their continuing efficacy.[368] In 1984, the Federal Reserve Board concluded that study. It noted that the authority to regulate margins for stock under the Securities Exchange Act of 1934 had three main objectives: (1) to restrain the diversion of margin credit from uses in commerce, industry, and agriculture; (2) to protect unsophisticated investors; and (3) to forestall excessive price fluctuations in the stock market.[369]

The Federal Reserve Board was not convinced that the margins goals originally set by Congress were still relevant.[370] First, it did not appear that governmentally set high margins were needed to achieve a balance in the distribution of available credit, because the total availability of funds for capital formation was not likely to be affected by margin borrowings, even if these substantially increased.[371] This was so because the direct use of credit to finance stock transactions played a much smaller role in the American economy than it had in the early 1930s.[372]

The Reserve Board Study stated that relatively high federal margin requirements for securities had the desirable effect of providing protection for small, unsophisticated investors.[373] But it added that there were methods preferable to high margin requirements for protecting unsophisticated traders, including risk disclosures.[374]

> There have been a number of empirical studies showing that increases in the level of margin requirements are not followed by decreases in the level of stock prices. On the surface, this finding suggests that margin requirements are an ineffective (and therefore unnecessary) public policy tool. However, the empirical evidence, taken by itself, does not provide a sufficiently powerful case for eliminating margin requirements. In part, this is true because that evidence does not rule out other possibilities such as (1) Federal Reserve margin requirements have never been so low as to permit significant speculation, or (2) the Board has always acted to raise margin requirements before speculation becomes at all widespread.

Id. at 7-8. The study concluded that the existing regulatory framework should be retained but that there was not an overwhelming case on either side for retaining or eliminating margin regulation. *Id.* at 9-10. One alternative considered was a stock specific approach to margin requirements in which individual stock issues that demonstrate speculative characteristics would have specialized margin requirements. *Id.* at 13. But the study noted difficulties with this approach, such as the need for establishing complex and expensive monitoring capabilities, designing tests to identify speculative behavior, and placing the Board in the difficult position of making judgments on stock classifications. *Id.* at 13-14. It was also suggested that listed stock options were a market innovation that might facilitate significantly greater amounts of leveraged speculation, which might imply a need for more, rather than less, regulation by the government. *Id.* at 3.

368. Reserve Board Study, *supra* note 30. *See also* Helms Letter, *supra* note 255. For a further discussion of the Federal Reserve Board's Study, *see supra* notes 256-67 and accompanying text.

369. Reserve Board Study, *supra* note 30, at 114. *See also Helms Letter, supra* note 255, at 2; Climan, *supra* note 333, at 209-10 (justifications for security credit regulation discussed).

370. Reserve Board Study, *supra* note 30, at 114.

371. *Id.*

372. Helms Letter, *supra* note 255, at 2.

373. Reserve Board Study, *supra* note 30, at 114.

374. *Id.*

The Federal Reserve Study "cast significant doubt on the need to retain high initial margins to prevent excessive fluctuations of stock prices" because credit-financed trading had not proved to have an important influence on stock prices.[375] Over the last fifty years, the "amplitude of fluctuations in stock prices had not differed greatly from that recorded before the imposition of federal margin regulations, with the exception of the late 1920s."[376] The study further noted that the character of the stock market had changed because institutions were now a much larger factor, and they did not trade on margin.[377]

The Federal Reserve Board, therefore, advised Congress that its study raised serious doubts about the need for continuing federal regulation of margin to foster the objectives originally sought by Congress in 1934. The Board believed that "the primary purpose of margin regulation today should be to ensure the integrity of the marketplace, in large part by seeing that there are adequate protections against significant loss to brokers, banks, and other lenders."[378] At the same time, the Department of Treasury advised Congress that the Vice-President's Task Group on regulatory reform of the federal government had proposed that federal margin regulation be eliminated, or at least confined to emergency situations.[379]

D. *Options Margining Systems*

1. Securities Options

The creation of the Chicago Board Options Exchange, Inc. ("CBOE") in 1973 raised new issues about securities margin because the risks being margined were more similar to futures risks than traditional securities risks. The CBOE was created by the Chicago Board of Trade to apply commodity futures trading principles to securities trading.[380] This exchange was quickly copied by other securities exchanges.[381] Initially, disparate margin requirements were imposed

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375. Helms Letter, *supra* note 255, at 3.

376. *Id.*

377. RESERVE BOARD STUDY, *supra* note 30, at 15, 117. *See generally Stock Margin Requirements, Are the Rules Obsolete?* Los Angeles Daily J., Feb. 5, 1985, at 4, col.1 (Congress should require securities industry to set and control its own margin rules, subject to oversight by federal authorities).

378. Helms Letter, *supra* note 255, at 3.

379. *See supra* note 268 and accompanying text for a discussion of this proposal. Most of the Task Group believed that the Reserve Board's margin responsibilities should be eliminated, but decided that the issue should be further reviewed after the Reserve Board Study. OFFICE OF THE VICE PRESIDENT OF THE U.S., BLUEPRINT FOR REFORM: THE REPORT OF THE TASK GROUP ON REGULATION OF FINANCIAL SERVICES 92-94 (1984).

380. *See* Board of Trade of the City of Chicago v. SEC, 677 F.2d 1137, 1140 n.2 (7th Cir.) (creation of CBOE discussed), *vacated as moot*, 259 U.S. 1026 (1982). *See generally SEC/CFTC Jurisdictional Issues*, *supra* note 14, at 111 (origin of CBOE explained). Prior to the creation of the CBOE, options were traded over-the-counter. H. FILER, UNDERSTANDING PUT AND CALL OPTIONS 80-81 (1959). Before the stock market crash of 1929, a holder of an option could trade against it without margin on the stock position. *Id.* Later, however, all stock commitments had to be covered by margin requirements, and options were not permitted as a substitute. *Id.*

381. The American Stock Exchange created an options exchange, as did the Philadelphia Stock Exchange and the Midwest Stock Exchange (Midwest later consolidated with the Chicago Board

by the various options exchanges. By 1977, however, a common margin system had emerged for the exchanges trading securities options.[382] Under this system, buyers of options were required to pay the premium in full, while writers of call options were required either to cover them fully or to post initial margin and maintain margin in an amount equal to thirty percent of the current market value of the stock subject to the options.[383] Writers of call options were further required to make up for any losses incurred on open positions.[384] In January of 1977, the Federal Reserve Board promulgated regulations that essentially adopted this system.[385] This margin system is a hybrid. The deposit of margin by an options writer (the "short") "is functionally equivalent to the 'good faith' deposit made by one who sells a futures contract."[386] It also has the marked-to-market feature of variation margin[387] for short traders, as well as an initial margin requirement that is substantially higher than that generally found in the futures industry (thirty percent versus five percent or less). That higher margin requirement has not impeded the growth of the stock options exchanges. Their volume grew from zero in 1973 to almost 300 million contracts before the stock market crash of 1987.[388] On the other hand, the options exchanges did not perform any better or have less volatility than the futures exchanges during the stock market crash of 1987. Indeed, if anything, the options exchanges did not perform as well as the futures exchanges,[389] and trading volume dropped sharply on the options exchanges after the crash because of an apparent lack of

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Options Exchange). Subsequently, the New York Stock Exchange also was authorized to trade options. *See generally* Seligman, *The Structure of the Options Market*, 10 J. CORP. L. 141, 142 (1984) (initiation of options trading on securities exchanges discussed); II LOSS & SELIGMAN, *supra* note 270, at 1066-71 (development and subsequent regulation of options trading discussed).

Securities options that are traded on organized exchanges are all cleared by a single clearing corporation — the Options Clearing Corporation. BULLS AND BEARS, *supra* note 361, at 190-93. *See also* AMERICAN STOCK EXCH., INC., CHICAGO BD OPTIONS EXCH., INC., PACIFIC STOCK EXCH., INC., PHILADELPHIA STOCK EXCH., INC., UNDERSTANDING THE RISK AND USES OF LISTED OPTIONS (Oct. 1982) (role of options clearing corporation discussed); THE OPTIONS CLEARING CORPORATION, EXCHANGE TRADED PUT AND CALL OPTIONS (Oct. 29, 1979) (overview of put and call options issued by OCC).

382. SPECIAL STUDY OF THE OPTIONS MARKETS, *supra* note 335, at 66.

383. *Id.* at 66-67

384. *Id.*

385. *See id.* at 67-69 (describes securities and option exchanges margining system; includes description of exemptions allowed for marketmakers, who may post less margin than public customers and who need not post any margin at all if positions are not carried more than five days); RESERVE BOARD STUDY, *supra* note 30, at 53 (Board promulgated regulations for all options in January of 1977). In fact, the SEC maintains oversight authority over margin setting by the options exchanges. It is now seeking legislation that would give it similar authority over futures margins. *See, e.g.*, Letter from Jeanne S. Archibald, Acting General Counsel, Department of the Treasury to Dan Quayle, President of the Senate, June 5, 1990 (transfer of authority to SEC to oversee both stock index futures and options on futures recommended).

386. *Hearings on Silver Prices*, *supra* note 201, at 86.

387. *See supra* note 15 and accompanying text for discussion of concepts of variation margin and the marked-to-market feature.

388. OCTOBER 1987 MARKET BREAK, *supra* note 20, at 8-19.

389. *Id.* at 8-20. The report on the Stock Market Crash found that the most actively traded index options contracts on the options exchanges did not provide an effective continuous market on

confidence in that market.[390]

The Federal Reserve Board believes that the function of margin in the futures and securities options markets is closely analogous.[391] To the extent that control of leverage is an important goal of margin, the failure to have comparable federal regulations over each would undermine the effects of more stringent margin requirements in the regulated market.[392] In the Board's view, such disparity could "create artificial competitive imbalances between markets."[393] Therefore, the Federal Reserve Board, as noted above, asserted authority over margins on futures contracts on stock indexes.[394] At that time, it believed that an index future contract was functionally similar to an option, and if such trading expanded substantially, it would reduce the efficacy of the Federal Reserve's margin requirements in protecting investors and preventing speculative movements in securities prices. Arbitrage between markets would quickly cause any speculative efforts in the futures markets to be reflected in the stock markets as well.[395] An exchange has argued, however, that disparities in margin requirements between the securities options markets and the futures markets suggest that the Federal Reserve Board should have no authority over stock options margins rather than be given additional authority.[396]

2. Commodity Option Margins

The CFTC regulates options on commodities and futures contracts. As a result of abuses for over 100 years, several attempts have been made to prohibit virtually all trading in commodity options contracts.[397] In 1978, the CFTC suspended nearly all options trading[398] but, in June of 1981, the CFTC published a proposal to allow domestically traded commodity options on regulated

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October 19 and October 20, 1987. *Id.* There were also pricing problems that raised serious concerns about the fundamental fairness of the stock option markets. *Id.*

390. *See* McMurray, *CBOE To Reduce Staff More than 10%; Trading Plunge In Index Options Cited*, Wall St. J. Jan. 8, 1988, at 3, col.2 (post-market crash reduction in CODE staff discussed).

391. *SEC/CFTC Jurisdictional Issues*, *supra* note 14, at 316.

392. *Id.*

393. *Id.*

394. *Id.*

395. *Id.*

396. *See CFTC Reauthorization: Hearings on H.R. 5447 Before the Subcomm. on Conservation, Credit and Rural Development of the House Comm. on Agriculture*, 97th Cong., 2d Sess. (1982) (proposals to grant FRB authority to set margins for options and exempt securities opposed by Comex).

397. *See* J. MARKHAM, THE HISTORY OF COMMODITY FUTURES TRADING AND ITS REGULATION 8-9, 57, 150-53 (1987) (history of prohibitions on privilege trading discussed; Commodity Exchange Authority adopted regulation prohibiting registered futures merchants from trading puts and calls; abuses led CFTC to suspend options trading in 1978); Markham & Gilberg, *Stock and Commodity Options - Two Regulatory Approaches and Their Conflicts*, 47 ALB. L. REV. 741, 769-71 (1983) (lack of coherent system of regulation and widespread abuses in options industry led to exclusive regulation by CFTC and suspension of trading); Schobel & Markham, *Commodity Options - A New Industry or Another Debacle?*, SEC Reg. & L. Rep. No. 347 (D.N.A. at 4-5 (special suppl. April 7, 1987)).

398. 17 C.F.R. §§ 32.1-32.4. This suspension was enacted into law. Futures Trading Act of 1978, Pub. L. No. 95-405, § 2, 92 Stat. 865 (codified as amended in scattered sections of 7 U.S.C.).

futures exchanges. In making this proposal, the CFTC stated that it was assuming that the domestic commodity options exchanges would determine the margin levels for such contracts, just as in the case of futures contracts.[399] But the CFTC noted that the Federal Reserve Board set margin levels on equity securities options.[400] The CFTC, therefore, requested comment on whether the CFTC or the exchanges should set margin requirements. It further asked those who believed the CFTC should set margins to comment on what factors the CFTC should consider in determining appropriate margin levels.[401]

Subsequently, the CFTC determined that it would prohibit the margining of option premiums by long purchasers of options, that is, option premiums would have to be paid in full.[402] The CFTC stated that its rule was not a margin setting rule, although it believed that it had the authority to regulate options transactions completely, including margin requirements.[403] It also stated, however, that levels for short sellers of uncovered options should be set by the exchanges.[404] The CFTC believed the characteristics of the options markets for short sellers and the futures markets for short traders were similar.[405]

The CFTC later permitted traders on the floor of the exchanges to use long options positions to offset partially short options positions and short futures positions, so that the amount of margins posted would be reduced. But there still remained a disincentive for floor traders to purchase options because the premium had to be posted in full. Some were concerned that this restriction could impair market liquidity. Indeed, the CFTC margin system for market makers was more restrictive than the system for the securities options traders. Therefore, in 1983, the CFTC sought comment on whether it should adopt a system similar to that used to margin securities options positions for market makers in

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399. [1980-1982 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 21,209, at 24,986-87 (June 29, 1981).

400. *Id.*

401. *Id.*

402. [1980-1982 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 21,263, at 25,290 (Nov. 3, 1981). A purchaser of an option pays a stated amount for the right to buy a specified commodity or commodity future at a specified price. In other words, a fee or a "premium" must be paid for the option right. The premium is the inducement for the opposite party to grant the option. *See generally* Long, *The Naked Commodity Option as Security*, 15 WM. & MARY L. REV. 211, 230 (1973) (security options include the right to purchase certain interests, includes naked option contracts); Lower, *The Regulation of Commodity Options*, 1978 DUKE L. J. 1095, 1102-09 (1978) (emergence of various types of commodity options discussed). The CFTC was requiring the premium to be paid in full so that this portion of the transaction could not be margined in any way.

403. Comm. Fut. L. Rep., *supra* note 402, at 25,290. Section 4c of the Commodity Exchange Act grants the CFTC plenary jurisdiction to regulate commodity options contracts, and that provision does not exclude margin from the ambit of CFTC regulation. 7 U.S.C. § 6c.

404. Comm. Fut. L. Rep., *supra* note 402, at 25,291.

405. *Id.* A short call options trader agrees to sell a commodity or commodity futures contract at a specified date in the future. If the options seller owns the commodity then he is said to be covered. This means that he has possession of the commodity. In such cases, the option will be fully covered. However, the commodity options exchanges do not have control of the cover. Therefore, just as in the case of futures contracts, they require that a margin deposit be placed at the exchanges and that maintenance margin be maintained.

the securities markets.[406] This would, in effect, allow margining of option premiums paid by floor traders.[407]

Still later, the CFTC sought comment on a proposal to allow a so-called "delta" margining system for commodity futures options that would apply to all members of the exchanges.[408] This system would permit the market value of long options, as adjusted by a formula for the risk of one day's market movement, to be used to reduce the aggregate market obligations on short option positions and on futures positions held in member accounts.[409] The CFTC also proposed regulations to allow commodity option exchange members to make a deposit of an amount less than the full premium for a long option position.[410] Such a deposit would reflect the risk of holding the position, as well as a safety surcharge for large positions.[411] Under this proposal, public customers (non-exchange members) would still have to make a deposit of one hundred percent of the option premium, and they would not be permitted to withdraw that premium or any amount reflecting a subsequent increase in the value of the option position.[412] The CFTC believed that it needed to retain the requirement as it applied to public customers for a couple of reasons: 1) to ensure the safety of customer funds; and 2) to assure that customers were not misled into believing that they had fulfilled their obligations on an option contract when they had paid only a portion of the option premium.[413]

A large default that occurred on the Commodity Exchange Inc. as a result of a concentrated options position raised new issues on option margins.[414] Although this did not alter the CFTC's belief that primary responsibility for setting levels of margins should rest with the commodity exchanges, the CFTC believed that the default required the adoption of formal guidelines for the pay-

406. [1982-1984 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 21,681 at 26,611 (Mar. 15, 1983).

407. *Id.* at 26,612.

408. [1982-1984 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 21,884 at 27,762 (Oct. 31, 1983).

409. *Id.*

410. [1982-1984 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 22,027 at 28,600 (Mar. 9, 1984).

411. *Id.*

412. *Id.*

413. *Id.* at 28,606.

414. *See generally Commodity Account Protection, A Study by the Division of Trading and Markets* (1985); Interpretation by the CFTC Office of General Counsel on Use of Segregated Funds By Clearing Organizations Upon Default by Member Firms (July 1985); Letter from Andrea M. Corcoran to Mr. Robert Mialovich, Assistant Director, Division of Bank Supervision, FDIC (July 3, 1984); Memorandum from Andrea M. Corcoran to the CFTC (July 23, 1985); Memorandum to the CFTC from Andrea M. Corcoran Concerning Reissuance of Division of Trading and Markets Financial Segregation Interpretation No. 4-1 (July 23, 1985); *Memorandum to the CFTC From Andrea M. Corcoran* (July 19, 1985); [1986-1987 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 23,039 at 32,071 (May 13, 1986) (default of Volume Investors Corporation exception to overall success of option program); Report of the CFTC Division of Trading and Markets on Volume Investors Corporation (July 1985); Statement by Andrea M. Corcoran, Esq., Director of CFTC Division of Trading and Markets on Volume Investors Corporation (July 29, 1985); Statement of Commissioner Robert R. Davis at CFTC on Volume Investors (July 29, 1985).

ment and collection of options margin.[415] It thought that the failure to assess and collect adequate margin might result in the default of one customer, and those losses might directly affect the funds of other customers.[416] The CFTC's proposed guidelines specified that the full amount of each option premium must be received for option customers at the time the option was purchased.[417] It also set limitations on using long options position to margin other option positions.[418] But the CFTC guidelines would allow a long option position to be used to margin a futures position if it was related to that long option position.[419] The proposed guidelines also stated that gains in long option positions could not be released before the option position was liquidated, and short positions would be subject to initial margin.[420] Further, any commodity—to cover a position that was claimed to be covered by ownership of the commodity must be in the possession or control of the exchange member.[421] The CFTC proposal stated that combinations of options and straddles, spreads and similar trading requirements would be subject to lower margin requirements, but such margins could not be less than zero.[422] The CFTC proposed guideline also would have allowed lesser restrictions on exchange members by not requiring the option premium to be paid in full.[423]

Still later, the question arose whether cross-margining should be permitted for commodity options, commodity futures and securities options. Traders cross-margin by using, securities options to secure futures transactions or vice versa, thereby reducing margin requirements for both positions.[424] The SEC urged that margin requirements should be coordinated and that a system of cross-margining between securities options and futures contracts or commodity options would better reflect net risks in the market.[425] The SEC thought that cross-margining would strengthen the integrity of the clearing system because a hedger could offset an increase in value of one position with an increase in a risk in an opposite position.[426] Cross-margining could also allow net cash settlements for activity in different markets. This would reduce liquidity requirements in times of stress and would permit more efficient use of capital.[427]

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415. [1984-1986 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 22,660 at 30,792 (Aug. 5, 1985).

416. *Id.*

417. *Id.* at 30,793.

418. *Id.*

419. *Id.*

420. *Id.*

421. *Id.*

422. *Id.* at 30,793-94.

423. *Id.*

424. [1986-1987 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 23,351 at 32,973 (Nov. 13, 1986).

425. *Id.*

426. *Id.*

427. OCTOBER 1987 MARKET BREAK, *supra* note 20, at 10-57. *See generally* Hinkes, *Cross Margining And Futures Style Margining: The Facts*, COMMODITIES L. LETTER, Nov./Dec., 1988, at 7 (cross-margining is economically logical approach to margining market risk of stocks, options and futures); Rutz, *Intermarket Cross-Margining: The Myth And The Reality*, COMMODITIES L. LET-

The CFTC has not adopted a cross-margining system because of concerns that it could jeopardize clearing systems through a domino effect in the event of a large market crisis.[428] In March of 1989, however, the CFTC published proposals by two exchanges that would have adopted a futures style margining system for commodity option contracts. The proposed system would have an original margin that the exchanges would assess according to the underlying risks. This system would apply to option premiums for longs as well as to the positions of short sellers. In addition, variation margin would reflect the daily changes in the value of the premium. Long and short options positions would be marked-to-market and gains and losses would be paid and collected daily, just as in the case of futures contracts. The exchanges asserted that this futures type of margining would improve cash flows and operation of the options markets generally, thereby increasing their liquidity and efficiency. In submitting this proposal, the exchanges noted that a Presidential Working Group, formed in the wake of the stock market crash of 1987, had recommended that market participants and regulators study the potential of improving liquidity through the use of futures-style margin for options.[429]

In considering this proposal, the CFTC compared the differences between the margin system used for stock options and the proposed futures-style margin system. Under the securities options margin system, the long option purchaser is required to pay the full premium price, while the short trader must post the full premium received from the long trader, plus an initial margin requirement. Thereafter, the long trader pays no additional funds and receives no additional funds. A short trader receives additional funds if the value of his position increases or pays additional funds if his position decreases in value. Under a futures-style margin system, both the long and short traders would post their initial margin, which would be based on the exchange's estimate of risk factors, just as in futures contracts. Thereafter, both parties would receive or pay maintenance margin depending on the increase or decrease in value of their positions. A long trader would be required to put up a smaller initial payment to purchase his option than required under the current commodity options margin system. This would introduce a risk of default in instances where long positions were not paid in full. There would be advantages to traders, however. These advantages would include more efficient cash flows across markets and a decrease in the need for additional funds in some trading strategies. The CFTC sought public

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TER, Nov./Dec. 1988, at 5 (cross-margining systems may have reduced liquidity problems for many firms had they been in place during market crash).

428. *See generally* Andrea M. Corcoran, *Aftermath of the Crash: Policy Assessments, Public Perceptions and Prospective Reforms, Address Before the Japanese Center for International Finance*, 23 (1988) [hereinafter *Aftermath of the Crash*]; Chicago Board of Trade, *The Chicago Board of Trade's Response to The Presidential Task Force on Market Mechanisms*, Part 3 at 19 (1987).

429. [1987-1990 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 24,411 at 35,806 (Mar. 17, 1989). The Presidential Working Group on Financial Markets had also discussed advantages of cross-margining that could be coupled with futures style margining. *Id. See generally* Hinkes, *supra* note 427, at 18 (futures-style margining discussed); Rutz, *supra* note 427, at 6 (President's Working Group urged testing of futures-style margining for options).

comment on this proposal.[430]

These proposals are still being considered, but several exchanges already have adopted a margining system called Standard Portfolio Analysis of Risk ("SPAN") which treats futures and commodity options uniformly for margin purposes.[431] Some forms of cross-margining is also being permitted, but for the most part this is limited to transactions conducted for proprietary accounts of exchange members; cross-margining is not generally permitted for customer transactions.[432] The history of option margins suggests a few things. First, the exchanges in both the securities and futures markets are fully capable of setting margins for leveraged instruments. Second, the government can play a residual role in option margin setting, but it will not grant market efficiency the same degree of importance that it attaches to maximizing customer protection. Third, government oversight will block or long delay any changes in the margin system.

III. The Stock Market Crash of 1987 Renews the Debate

A. The Stock Market Crash

The stock market crash in October, 1987 raised significant concerns about the lack of federal oversight of commodity futures margins. During the crisis, the number and size of margin calls resulted in rampant rumors concerning the economic viability of clearing houses and other market participants.[433] On one day alone, initial and variation margin payments to the futures markets for the Chicago Mercantile Exchange totaled $2.5 billion.[434] This is in contrast to the usual average daily payments of $100 million on that exchange.[435]

The size of these sums caused significant payment delays by two major clearing house members, and an emergency capital infusion for the options clearing house was necessary during that period.[436] Two New York Stock Exchange clearing organizations which were owed $1.5 billion received their funds several hours later than usual.[437] Because of the uncertainty, some banks withdrew uncommitted lines of credit and placed tighter restrictions on new loans to market participants. This resulted in a general lack of confidence and raised the possibility of a full scale financial system breakdown.[438] Although the Federal Reserve Board assured the market that it would provide necessary liquidity, the

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430. [1987-1990 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 24,411 at 35,806 (Mar. 17, 1989).

431. Chicago Mercantile Exchange, A New Margining System, Standard Portfolio Analysis of Risk (1989). *See also* Bulls and Bears, *supra* note 361, at 86, 102-104 (discusses status of cross-market margin developments); Hargreaves, *Time For Players To Take Their Pick*, Financial Times, Dec. 12, 1990 (discusses cross-market margining efforts in London).

432. Horwitz & Cawley, *Cross-Margining: A Clearing Perspective*, Commodities Law Letter, No. 9 & 10 at 1 (Nov./Dec. 1990).

433. S. Rep. No. 300, 101st Cong., 2d Sess. 27-28 (1990).

434. *Id.*

435. *Id.* at 28 n.122.

436. *Id.* at 28.

437. *Id.*

438. *Id.*

uncertainty that existed before that announcement was found to have contri uted to market volatility.[439]

B. Congressional Review and Presidential Action

The stock market crash of 1987 resulted in the appointment of a Presiden tial Task Force (the "Brady Commission") to investigate the cause of the crasl and to recommend reforms.[440] The commission concluded that margin level should be "rationalized across markets."[441] Although margins had been suffi cient to assure performance, the Brady Commission believed that low future margins could affect the degree of speculative activity and the risk to the finan cial system as a whole.[442] The commission asserted that there should be simila margins in futures and stocks that would result in roughly equivalent risk an leverage between the two markets. The Brady Commission further recom mended that such margin setting authority be given to the Federal Reserv Board.[443]

The SEC joined the Brady Commission in seeking a harmonization of mar gins between the futures markets and the stock markets, as well as other re forms.[444] But the commodity exchanges and the CFTC strongly disagreed witl

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439. *Id. See also Performance of The Equity Markets: The Clearinghouses and the Banks*, COM MODITIES L. LETTER, Mar. 1988 at 8 (absence of commodity account insurance during marke break contributed to uncertainty in financial system).

440. BRADY REPORT, *supra* note 361.

441. *Id.* at 64.

442. *Id.* at 65.

443. *Id.*

444. *See "Black Monday," The Stock Market Crash of October 19, 1987: Hearings Before th Senate Comm. on Banking, Housing, and Urban Affairs*, 100th Cong., 2d Sess. 157 (1988) (testimon of David S. Ruder, Chairman of the SEC) (SEC recommended formal regulatory consolidation o stock index futures and stock markets); BRADY REPORT, *supra* note 361, at 65 (margins on future need to be consistent with margins for professional market participants). The New York Stocl Exchange took a more restrained view. A special panel created by that exchange stated that:

> The Panel believes that each exchange should have the responsibility to set its own margin requirements because it can best assess volatility and default risk. In particular, the Panel does not believe that margin levels should be made equal across markets because the same amount of protection against default can be provided by different margins in different markets. Since equity index futures are based upon a broad-based index that is less volatile than individual securities, their default risk is lower. In addition, the futures exchanges require margin levels to be restored within hours and require settlement on the next business day, while securities exchanges typically allow a longer time for margins to be restored and allow five business days for settlement. Therefore, margin levels in the futures and equity markets should legitimately differ, given current settlement practices and risks.
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> A majority of the Panel believes that transferring oversight of margins to a single federal agency while leaving authority to set margins with the exchanges could have several benefits. First, it could help assure investors that all markets have the same level of financial integrity. Second, oversight by a single agency could be useful in setting uniform standards for risk-adjusted margins and encouraging cross-margining. In addition, a single federal agency could encourage improvement in clearance and settlement systems.
>
> Other Panel members believe that the current arrangements for setting and regulating margins work well, and that no centralized oversight is required. Margins on individual equities and stock index futures are sufficient to prevent defaults, and the current system

the Brady Commission's recommendations on margin.[445] The exchanges again argued that margins for stock and futures served fundamentally different purposes.[446] They further argued that raising margins would reduce liquidity in the markets.[447] Moreover, during the crash, performance in the securities and options exchanges had been no better than that in the futures markets.[448]

In February, 1988, the Senate Committee on Banking, Housing and Urban Affairs conducted hearings on the stock market crash of 1987.[449] During these hearings, the Chairman of the SEC, David S. Ruder, recommended temporary futures margin increases.[450] Instead, on March 18, 1988, President Reagan issued an Executive Order that established a Working Group on Financial Markets (the "Working Group").[451] Chaired by the Under Secretary of the Treasury, the Working Group included the Chairmen of the Federal Reserve, the SEC, and the CFTC. The Working Group was ordered to recommend to the President legislative changes to prevent a recurrence of the stock market crash of 1987.[452] The Working Group initially expressed the view that cooperative efforts would be more effective and less disruptive than a more formal legislative approach.

The Working Group discussed margin, among other things. Although the SEC Chairman stated that margin levels should be raised to control market volatility, other members of the Working Group did not share that view. The CFTC and the futures exchanges cited the 1984 Reserve Board Study for the

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> need not be changed. These Panel members fear that giving oversight of futures margins to a single federal regulator who is more concerned with risk than with costs may result in margins that are too high. This situation would harm the equity markets and hinder the capital formation process.

MARKET VOLATILITY AND INVESTOR CONFIDENCE: REPORT TO THE BOARD OF DIRECTORS OF THE NEW YORK STOCK EXCHANGE 10 (June 7, 1990). *See also Volatility and Panic in the Nation's Financial Market, Hearings Before the Senate Comm. on Banking, Housing, and Urban Affairs*, 100th Cong., 1st Sess. 71-72 (1987) (Federal Reserve as appropriate agency to set margins for index futures and similar products discussed).

445. S. REP. No. 300, *supra* note 433, at 36.

446. *Id.*

447. *Id.*

448. In fact, several securities firms had net capital problems, and one firm had to be liquidated by the Securities Investor Protection Corporation ("SIPC"). OCTOBER 1987 MARKET BREAK, *supra* note 20, at 5-13, 5-16. *Cf.* DIVISION OF ECONOMIC ANALYSIS, AND DIVISION OF TRADING AND MARKETS, INTERIM REPORT ON STOCK INDEX FUTURES AND CASH MARKET ACTIVITY DURING OCTOBER 1987 TO THE U.S. COMMODITY FUTURES TRADING COMMISSION 9-10 (1987) (discusses performance of commodity firms).

449. S. REP. No. 300, *supra* note 433, at 8. Hearings were also held in March of 1988. *Id.* At that time Chairman Greenspan noted that the margin issue remained controversial and that there was disagreement about what was needed in this area. *Legislative Recommendations*, *supra* note 335, at 23. "This lack of consensus appears primarily to reflect differences in objectives." *Id.* He noted that there was "much disagreement about the need for, or effectiveness of, higher margins to control speculation and limit stock price volatility." *Id.*

450. S. REP. No. 300, *supra* note 433, at 8.

451. Exec. Order No. 12,631, 53 Fed. Reg. 9421 (1988).

452. *Id.*

proposition that margin levels did not affect stock price volatility.[453] The Working Group, as a whole, found that margin levels had provided an adequate level of protection for financial systems. But the Chairman of the SEC remained unconvinced. He testified before Congress that legislation to address the inconsistencies in margins of stocks, options, and futures appeared necessary. The CFTC, however, again contended that further legislation was not necessary and that the Working Group would be the "appropriate forum for intermarket coordination issues."[454]

On May 16, 1988, the Working Group issued an interim report which did not address the issue of margins.[455] Nevertheless, the SEC continued to press the issue. On July 6, 1988, the SEC submitted legislation which would have allocated responsibility for setting margins to the securities and commodities self-regulatory organizations, and would have provided for regulatory oversight of "prudential" margins by the SEC and CFTC. Residual authority to regulate margins for all purposes would be given to the Federal Reserve Board.[456]

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453. S. REP. NO. 300, *supra* note 433, at 35-36. *See supra* notes 256-67 and accompanying text for a discussion of the Reserve Board Study.

454. S. REP. NO. 300, *supra* note 433, at 9. The SEC Chairman testified in Congress that he believed short term measures were necessary to dampen market volatility. *The Conclusions and Recommendations of the President's "Working Group on Financial Markets," Hearing Before the Senate Comm. on Banking, Housing and Urban Affairs*, 100th Cong., 2d Sess. 45 (1988) [hereinafter *Conclusions and Recommendations*]. "One of the least intrusive interim measures to accomplish this goal would be to increase margins on stock index futures and I have recommended that this step be taken." *Id.* The CFTC rejected that claim and argued in response that increased margins risked moving futures trading into off-shore markets. *Id.* at 62-63. Apparently, the Chairman of the SEC was the only person on the working group who believed that margins would dampen volatility. *Id.* at 73.

455. S. REP. NO. 300, *supra* note 433, at 8. In hearings on the Working Group's report, the Chairman of the Federal Reserve Board testified that:

> Beyond achieving margin levels adequate for market integrity, it has been argued frequently that they should be set at levels that will reduce price volatility. In particular, it is thought that the lower levels of margin on options and futures foster greater leverage speculation that in turn causes larger price fluctuations. This line of reasoning leads to the proposal that margins on derivative equity products be raised to levels more in line with those in the cash market.
>
> The empirical evidence, which is vast and expanding rapidly, does not, on balance, lend much support to this argument. The available analyses, including work done by the Board's staff in recent years, provide no convincing evidence that margins affect price movements in any significant way in the cash or futures markets. For example, the volatility of stock prices has not been significantly lower since the imposition of margin requirements; and changes in initial margin requirements on stocks has not been followed by predictable or significant changes in the stock prices. Moreover, with the expanding opportunities for credit that have characterized developments in our financial markets for some time, those who wish to speculate are little constrained by margin levels . . . . Thus, while higher margin requirements may impose somewhat higher costs on transactions in particular markets, margin requirements are unlikely to reduce in any meaningful degree the total amount of leverage in the economy.

Conclusions and Recommendations, *supra* note 454, at 41-42.

456. S. REP. NO. 300, *supra* note 433, at 11.

C. The Mini-Crash of 1989

A market disturbance in October, 1989 resulted in renewed and more strident calls for regulation. On October 13, 1989, the Dow Jones Industrial Average closed down more than 190 points (6.9 percent) for the day.[457] An SEC staff report concluded that speculative trading and large institutional activity fueled this market break. It also found "extraordinary price volatility" in which the nation's securities markets lost $190 billion in value, $160 billion of which was lost in a ninety minute period. The report stated that, under the current regulatory system, there was no assurance that there would not be a repeat of this volatility.[458] In contrast, a CFTC report on the market break found there had been no large trader activity or manipulation that caused price volatility.[459]

The mini-crash in October, 1989 resulted in an appeal to Congress by Nicholas Brady, the Secretary of the Treasury and former head of the Brady Commission. He asserted that there was a continuing potential for volatility in the markets and that inconsistent margins posed a danger.[460] The new SEC

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457. U.S. SECURITIES AND EXCHANGE COMMISSION DIVISION MARKET REGULATION AND DIVISION OF TRADING AND MARKETS ANALYSIS OF OCTOBER 13-16 1989 Es-1 and Es-2 (1990).

458. *Id.*

459. COMMODITIES FUTURES TRADING COMMISSION DIVISION OF ECONOMIC ANALYSIS, REPORT ON STOCK INDEX FUTURES AND CASH MARKET ACTIVITIES DURING OCTOBER, 1989 (May 1990) [hereinafter CFTC 1989 CRASH REPORT]. The SEC and CFTC both charged that each other's reports were misleading or that they distorted data. Salwen, *CFTC Rakes The SEC's Findings on Mini-Crash as Turf War Flares*, Wall St. J., June 28, 1990, at C1, col. 5; *SEC Chief Accuses CFTC of Distortion in Mini-Crash Probe*, Wall St. J., June 25, 1990, at C16, col. 6. *See generally U.S. General Accounting Office, Report on Securities and Futures Markets*, 2 Comm. Fut. L. Rep. (CCH) ¶ 24,890 (1990) (comments of the General Accounting Office on the SEC and CFTC Reports).

The conflict between the SEC and the CFTC was compounded by another dispute that arose between the two agencies in 1988 after the SEC authorized index participation contracts to be traded as securities on the CBOE. The commodity exchanges, and the CFTC, contended that the contracts were actually futures contracts that had to be traded on a commodity exchange, not the CBOE. The commodity exchanges challenged the SEC's action in court. Chicago Mercantile Exchange v. SEC, 883 F.2d 537 (7th Cir. 1989). The Seventh Circuit held that the SEC was not authorized to regulate those contracts, and that they were within the exclusive jurisdiction of the CFTC. *Id.* at 544.

460. S. REP. NO. 300, *supra* note 433, at 38. In a letter to the Senate Committee on Agriculture, Nutrition and Forestry, Secretary Brady stated that between 1930 and 1982 (the latter date being when the stock index futures began trading), the Dow Jones Industrial Average had declined by more than six percent on only three occasions. Letter from Nicholas Brady to Senator Patrick Leahy, Chairman Senate Committee on Agriculture, Nutrition and Forestry 1-2 (May 8, 1990). With the advent of futures trading, however, such massive one-day sell-offs had occurred on four occasions in the last three years. *Id.* Each occasion "shared the characteristics of enormous selling pressures in the stock index futures markets." *Id.* Brady stated:

> In the 52 years between 1930 and 1982 (the year stock index futures began trading) the Dow Jones Industrial Average declined by more than 6 percent on only three occasions: when the Germans took the Netherlands in May of 1940 (6.8 percent); when they encircled the Allied forces at Dunkirk just days later in the same month (6.8 percent); and when President Eisenhower suffered a heart attack in September of 1955 (6.5 percent). As the futures markets have grown, such massive one-day selloffs have occurred four times in the last three years. . . . None of those days that corresponded with any major news events like the ones before 1982. But they all shared the characteristic of enormous selling pressure from the stock index futures markets.

chairman, Richard Breeden, quickly formed an alliance with Brady to advocate legislation that would give the SEC authority over stock index futures contracts and authority to set margin requirements. This legislation would provide the SEC with authority to oversee the futures exchanges' ability to set margins, similar to its current authority over margin setting by the options exchanges. The statute, however, would not preset any minimum margin.[461] Nevertheless, the SEC chairman publicly proposed a national "speed limit" that would set a floor on commodity futures margins at a level of twenty percent.[462]

The Federal Reserve Board did not enthusiastically support the SEC and the Department of Treasury. On March 29, 1990, Alan Greenspan, Chairman of the Board of Governors of the Federal Reserve System, testified before Congress that, in the opinion of the Federal Reserve Board, the primary purpose of margins was to protect the clearing organizations, brokers, and other intermediaries from credit losses that could jeopardize performance on futures contracts.[463] Chairman Greenspan stated that the Federal Reserve Board was skeptical that setting margin on stock futures indexes at levels higher than necessary to assure performance would "reduce excessive stock price volatility."[464] Chairman Greenspan stated that available statistical evidence on the relationship between margins and stock price volatility was mixed.[465] The Federal Re-

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Id. Brady also asserted that futures margins were dangerously low, and that futures traders had so much leverage that they could "punch a hole in the fabric of the financial system." *Id.* at 2. Prior to the October 13, 1989 market break "a professional trader in the futures markets with $50,000 in cash could control almost $2 million in stock, which is nearly ten times more than [the] $200,000 that a professional trader in the stock markets can control with the same amount of cash." *Id.* Secretary Brady noted that stock index futures margins were actually lower in October of 1989 than they were in October of 1987. *Id.* "Since these margins are set by the futures industry, not a single regulator, there is no way to harmonize margins in the futures and stocks to protect the public." *Id.* Secretary Brady elsewhere stated that:

> As you know, the Task Force that I chaired on the 1987 Market Break recommended that margin requirements be harmonized between the equity and the derivative markets. In 1988, the Working Group concluded that the then-current margin requirements were sufficient for prudential purposes, and consistent between the two markets.
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> . . . .
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> . . . I am very concerned about these issues, because I believe there is a public interest involved beyond the private interest of the exchanges. I therefore intend to ask the Working Group to reconsider issues related to margin requirements.

The Market Reform Act of 1989, Joint Hearings on S.648 Before the Senate Subcomm. on Securities and the Senate Comm. on Banking, Housing and Urban Affairs, 101st Cong., 1st Sess. 211 (1989).

In response, the commodity exchanges pointed out that numerous studies of the stock market crash of 1987 had been conducted and that none of them had provided "evidence that would lead to the conclusion that futures margin was a factor in the crash." *Id.* at 130 (remarks of Leo Melamed).

461. Letter from Jeanne S. Archibald, Acting General Counsel, Department of the Treasury to Dan Quayle, President of the Senate, (June 5, 1990).

462. Salwen and McMurray, *Futures Shock, Tight Rein if SEC Reigns*, Wall St. J., May 17, 1990, at C1, col. 3.

463. *Testimony by Allen Greenspan, Chairman of Board of Governors of the Federal Reserve System Before the Subcommittee on Securities of the Senate Committee on Banking, Housing and Urban Affairs*, 101st Cong., 2d Sess. (Mar. 29, 1990).

464. *Id.*

465. *Id.*

serve Board believed that margin had not measurably affected volatility in either the cash markets or the futures markets. The Federal Reserve Board was not convinced that large price movements in the markets could be "attributed to the introduction of stock index futures and the opportunity they offer for greater leverage."[466] In fact, the Federal Reserve Board thought that raising stock margins could substantially reduce futures market liquidity or drive business offshore.[467]

Nevertheless, the Federal Reserve Board was concerned that there was a tendency on the exchanges to lower margins in periods of price stability and raise them during periods of extraordinary price volatility.[468] This had the effect of creating substantial liquidity pressures on brokers and others. The Federal Reserve Board believed that somewhat higher margin levels would obviate the need to raise them in a crisis.[469] Still, the Federal Reserve Board believed that the exchanges should continue to have primary responsibility for developing and refining margin policies, but with federal oversight. Chairman Greenspan acknowledged that either the CFTC or the SEC could play this oversight role.[470]

It is unclear what legislation may eventually result from the SEC's efforts to assume margin control and responsibility over index futures trading. A House bill would have authorized the CFTC to monitor margin levels set by futures

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466. *Id.*

467. *Id.*

468. In a letter to a congressional committee, Chairman Greenspan stated that he was concerned with the tendency of the futures exchanges to raise margins during volatile market periods, which he thought could "potentially add to liquidity strains in the system." Letter from Allen Greenspan, Chairman, Board of Governors of the Federal Reserve System, To Patrick Leahy, Chairman, Senate Committee on Agriculture, Nutrition and Forestry, (May 25, 1989). He added that the futures exchanges have "come to recognize more fully the potential difficulties caused when margin levels are set so low in a period of relative stability that they need to be raised in times of volatility. They now have built in a better cushion for such times." *Id.*

469. *Id.*

470. *Id.* In a May 2, 1990 address to the commodity futures industry, Chairman Greenspan further elaborated on his views about margin. A. Greenspan, Chairman of the Federal Reserve Board, Remarks Before the Joint Conference of the CFTC and the Futures Industry Institute 2 (May 2, 1990). He again observed that "the objective of margin regulation should be to protect the integrity of financial market participants." *Id.* Government oversight should be in place to guard against systemic risk. *Id.* He stated that he was particularly concerned about the tendency of clearing organizations to lower margins in periods of price stability to such a degree that the margins must be raised when prices increase in volatility. *Id.* He asserted that this practice "had the potential of compounding liquidity pressures on market participants and payment systems in times of stress." *Id.* The Chairman stated that "private market decisions may not always fully reflect systemic concerns." *Id.* at 2-3. He stated that he was slightly in favor of having a common regulator for futures and securities, because such a regulatory structure would assure "that prudential margin requirements across cash and derivative instruments are based upon the same assessment of price volatility." *Id.* at 7. But this did not mean that margin necessarily must be equal across products. Rather, prudential standards would be consistent. *Id.* at 7. In fact, the *Reserve Board Study* had stated that market participants had been successful in invoking margin levels sufficient to protect the integrity of the market even during the 1929 crisis, because no banks became insolvent due to their margin transactions and very few broker-dealers were unable to meet their commitments as the result of margin trading. RESERVE BOARD STUDY *supra* note 30, App. A, at 90.

contracts.[471] Under that bill, if the CFTC determined that such margins presented a "clear and present danger" to the integrity of the futures markets or to public interest, the CFTC could take action to assure that margin levels were sufficient to protect the public interest.[472] This provision seems to be analogous to that sought by the CEA many years ago.[473] But one compromise, suggested by the Federal Reserve Board, would provide for federal margin controls to guard against systemic dangers.[474] The House eventually passed a bill that would authorize the CFTC to monitor margin levels on stock index futures contracts for the purpose of assuring that margin levels are sufficient to maintain the integrity of the futures markets and to protect public interest.[475] The Senate also later approved a bill that would grant the Federal Reserve Board standby authority to direct contract markets to set margins on index futures contracts at levels the Board believes necessary to preserve the financial integrity of the contract market or its clearinghouse or to prevent systemic risk. The Board would be authorized to delegate this authority to the CFTC.[476] It is unclear how the House and Senate bills will be reconciled by the Conference Committee, if at all, or how the designated agency will use such authority. An open issue also remains as to whether there should be federal control margins on future contracts other than on indexes. This article concludes that the only appropriate role of the federal government in regulating margins is to guard against systemic risks.

IV. Protection Against Systemic Failures: The Only Appropriate Goal of Margin Regulations

The history of proposed federal regulatory control of commodity futures industry margin demonstrates that the issue is as subjective as it is confusing. For years, the government had sought federal margin controls to keep small investors from disturbing the markets through excessive and undercapitalized

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471. H.R. 2869, 101st Cong., 1st Sess., § 215 (1989); H.R. Rep. No. 102-6, 101st Cong., 2d Sess. 43 (1991).

472. *Id.*

473. *See supra* notes 102-10, 127-30 and accompanying text for a discussion of the earlier proposed legislation.

474. Nash, *Futures Bill Agreement is Expected*, N.Y. Times, July 27, 1990 at D1, col. 3. A Senate Committee also approved a bill that would have granted margin oversight authority to the Federal Reserve Board, but the oversight authority would be limited to stock index futures contracts and options. The Federal Reserve Board would be authorized to delegate its supervisory authority to the CFTC. Under this provision, control over margins would still remain with the exchanges, at least in the first instance. S. Rep. No. 22, 102d Cong., 1st Sess. 59 (1991).

Another House bill would have given the SEC power to regulate margins. H.R. 5006, 101st Cong., 2nd Sess. (1990). Further hearings were held on this issue on July 24, 1990. M. Lane, President, Discount Corporation of N.Y. Futures, Statement Before the Senate Comm. on Banking, Housing and Urban Affairs (July 24, 1990). For a discussion of recent legislative developments on the margin question *see*, Frankhauser & Levinson, *CFTC Reauthorization: Fourth Edition*, Commodities L. Letter, Sept. 1988, at 3; Hinden, *Chicago Futures Markets Again Facing Curbs*, Wash. Post, Feb. 8, 1991 at F3, col. 1; Robb, *Futures Traders Win in Regulatory Battle*, N.Y. Times, Oct. 24, 1990, at D13, col. 4.

475. H.R. 707, 102d Cong., 1st Sess., § 215 (1991).

476. H.R. 707, 102d Cong., 1st Sess, *as amended by the Senate*, § 301 (1991).

speculation. In the 1970s, however, small speculators were no longer playing a dominant role in the markets. The CEA (and its successor, the CFTC) then became a proponent of leaving margin regulation to the exchanges, except on a residual emergency basis.[477]

Similarly, the Federal Reserve Board, which is responsible for securities margin controls, concluded in the early 1980s that security margin controls were no longer needed to prevent a boom and bust in the securities markets, such as that experienced in 1929. The Federal Reserve Board, the CFTC, and the commodity exchanges argue that the only role of margins, whether for futures, commodities, or securities, should be to assure financial performance.[478]

The SEC, founded as a part of a congressional determination that margin had played a leading role in the speculation that led to Black Monday in 1929 and to the Great Depression, has taken a different view. The SEC has fought to maintain high margin requirements. It believes that margin controls are required to lessen market volatility. As a result of the stock market crash of 1987, the Treasury Department has now joined the SEC in that view.[479] These conflicting positions have led to the present and past debates before Congress. The following is a discussion of the most frequently asserted arguments.

A. *Arguments Against Federal Regulatory Controls*

The principal arguments against giving the federal government authority to control margins include the following:

(1) Increased margins will result in reduced liquidity and higher costs in the futures markets, and this will eliminate or impair commercial hedgers.[480]
(2) Futures margins are conceptually different from securities margins.[481]
(3) Futures markets need to set margin requirements to protect themselves, brokerage firms, and customers in general.[482]

The rest of this Section will discuss the merits of each of these arguments in turn.

1. It Is Uncertain Whether Increased Margins Will Reduce Liquidity

Hedging performs a valuable service, a function that the futures markets

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477. *See supra* notes 49-157 and accompanying text.

478. *See supra* notes 255-71 and accompanying text.

479. *See supra* notes 292-362, 453-54 and accompanying text.

480. *1948 Hearings, supra* note 28, at 54, 97; T. HIERONYMUS, *supra* note 12, at 320. *See supra* note 458-62 and accompanying text.

481. *1966 Hearings supra* note 129, at 67 (stock margins and futures serve fundamentally different purposes). The Federal Reserve Board's authority to set margin levels for securities is based on its role as a credit regulating agency. This is completely inapplicable to futures trading. *Id.* at 49. *See generally id.* at 67-68, 75-76; S. REP. NO. 300, *supra* note 433, at 36 (same).

482. *1948 Hearings supra* note 28, at 92, 104. *See generally*, Note, *The Role of the Commodity Futures Trading Commission Under the Commodity Futures Trading Commission Act of 1974*, 73 MICH. L. REV. 710, 755 (1975) (exchange officials in best position to weigh interests of diverse groups affected by margin level).

have served in the agricultural trade for over one hundred years.[483] Hedging also has became important in the financial markets in recent years because futures trading allows decreased spreads and more efficient financing.[484] Opponents of federal margin control, however, contend that increased margins would reduce liquidity by discouraging speculation or by increasing trading costs. The effect of this would be to impair the utility of the futures markets, because hedging operations would be discouraged or hampered.[485]

In fact, it is unclear what effect increased margins would have upon commercial hedgers, which almost inevitably are large institutional traders. Presumably, any increases would only relate to initial margin. Such margins can generally be posted with a clearinghouse in the form of Treasury bills, which return interest to the hedger.[486] Therefore, the incremental cost would appear to be small — that is, limited to the difference between what could be earned on a Treasury bill and what could be earned through a higher rate of investment in a medium that cannot be used for margin. This obstacle does not seem to be particularly great, particularly to institutions with millions, or billions, of dollars to invest in the markets. Those institutions generally seek advantages from hedging or other opportunities in the market, such as "index arbitrage."[487] These apparently provide high enough returns to offset the incremental costs of increased margins. Moreover, most institutions only place a small percentage of their assets in the markets. Consequently, they have a large reservoir of funds for large scale trading, even if margin requirements are increased dramatically. In addition, some institutional investors are prohibited from trading on margin and, therefore, fully fund their trading. They too would be undeterred by margin increases.[488] Consequently, it is doubtful whether an increase in margin requirements would reduce the ability of these firms to engage in massive trading.[489]

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483. *See supra* note 10 for a discussion of hedging practices.

484. *See generally* EFFECTS OF FUTURES AND OPTIONS, *supra* note 270, at I-11.

485. *See* B. CARROLL, FINANCIAL FUTURES TRADING (1989). One author has stated:

> Excessively high margin requirements would have adverse consequences for both direct users and indirect beneficiaries of competitive futures markets. As the cost of using the markets would be significantly increased, there would most likely be fewer participants and the efficiency of the futures market for hedging and price discovery purposes would be correspondingly decreased.

Id. at 31.

486. EFFECTS OF FUTURES AND OPTIONS, *supra* note 270, at II-13. In some instances letters of credit may be posted as margin. *Id.*

487. Index arbitrage involves efforts by traders to profit on the differences between stock index futures and the underlying stocks — *i.e.*, they buy the lower and sell the higher. *SEC Division of Market Regulation, The Role of Index-Related Trading in the Market Decline on September 11 and 12, 1986* at 4-5 (1987); LOSS & SELIGMAN, *supra* note 270, at 2647-50.

488. Salwen and McMurray, *Futures Shock, Tight Rein If SEC Reigns*, Wall St. J., May 17, 1990 at C1, col. 3 [hereinafter *Futures Shock*].

489. Another approach might be to "surcharge" variation margin. *See*, Talbot, Stock Index Futures: Manipulative or a Necessary Tool In an Evolving Market 38-39 (Jan. 1990) (unpublished thesis available at Georgetown Law Center) (surcharging variation margin discussed). For example, instead of requiring a posting of 100% of the loss on a trade, a trader could be required to post 200%

Increased initial margins, however, could discourage speculator interest in the market. Speculators provide liquidity for hedging operations.[490] Speculators may lack the capital to meet substantially increased margin requirements, or may be unwilling to dedicate capital to lower return investments, such as Treasury bills. But whether speculators in fact would be discouraged is not certain, since many of them are large institutions or floor traders who close most of their positions daily. There is no margin cost for positions closed during the day.[491]

Higher initial margin requirements might diminish the size of positions held overnight by speculators who would have to post large amounts of Treasury bills. If that is true, the liquidity and the overall usefulness of the market may be impaired. It is unclear, however, whether the position size of speculators would shrink. Therefore, before margin regulation is pursued, greater study is needed. First, a survey of the amount of speculative interest in the market must be performed. Then, the amount of capital available to such traders must be examined, as must the projected effect that increased margins would have on profitability and traders' willingness to continue to trade at given levels. The effect of increased margin requirements could then be determined. For example, if speculative interest in overnight positions is high, and capitalization is low, margin requirements could have an adverse effect on liquidity. In the absence of such a study, this simply remains a theoretical possibility, albeit one of serious importance.[492]

2. Distinctions Between Commodity and Security Margins Are Not Significant

The second of the arguments in opposition to margin control merely states a truism; that is, there are differences between futures and securities margins. But the extent or significance of these differences is unclear. The exchanges argue that margin payments are not down payments on a futures contract.[493] But this distinction may not be as meaningful as the exchanges contend. For example, a long trader is required to post initial margin. Assuming that the trader takes delivery on that contract, the value of that initial margin is credited against the eventual purchase price of the commodity that is delivered. Initial margin,

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of the loss. This raises conceptual problems, such as whether these super margins should be paid out at the other end to the winning trader. But it also would impose greater borrowing or carrying costs on hedgers, because variation funds must generally be posted in cash.

490. *See supra* note 9 for a discussing of the role of speculation in the securities markets.

491. *Futures Shock*, *supra* note 488, at C1, col. 3.

492. Empirical data on the effect of margin is limited. *Takeover or Stalemate*, *supra* note 2. The Chairman of the CFTC has stated that institutions that are hedging hold the largest positions in stock index futures contracts. *Legislative Recommendations*, *supra* note 335, at 121. During the October, 1987 Stock Market Crisis such institutions held approximately 65 percent or more of total open contracts in the S&P 500 Stock Index Futures Contract, which is the largest index contract. "Large speculators, in contrast, held less than five percent of total open interest." *Id.* This would suggest that restrictions on large individual speculators may not pose too great a danger to liquidity.

493. *See supra* notes 225-32 and accompanying text for a discussion of what the exchanges believe margin payments represent.

therefore, may serve in the role of a down payment. Similarly, variation margins paid out during the life of the contract to reflect losses do no more in the case of a long trader than demonstrate the commodity's decrease in value. This too is simply preserving the value of the initial down payment on the underlying commodity, and the payments are credited to the purchase price. In other words, a long trader does not have to pay twice.[494]

The conceptual differences between a short trader in the commodity futures markets and a short trader in the stock markets also do not appear to be that great. Both are often selling something they do not own. A securities trader borrows stock for sale or loan to a third person, but he must be able to secure its replacement at a later date.[495] A commodity futures trader may be selling something he does not own, and he must be able, at least theoretically, to secure it at the time of delivery. In both instances, the amount of initial margin put down by the parties simply reflects a deposit payment to assure that they will have funds on hand sufficient to secure their performance on the agreement to return the commodity.[496] Maintenance margin requirements operate in a similar fashion.

494. When delivery is made on a futures contract the contracts become individualized, but original margin deposits are maintained by the clearing house until delivery is effected. Generally the clearing house will release the original margin deposits to both clearing members after delivery and payment have been made. But because the price of the futures contract at the time of delivery will parallel that of the physical commodity, and because all margin calls and payments have been made up to the time of delivery to reflect changes in market price, delivery will take place at or very near the prevailing market price. Initial margins are then either credited by the clearing member to the payment price or returned to the parties. Consequently, the initial margin deposit will be used or can be credited against the eventual payment price. *See generally SEC/CFTC Jurisdictional Issues*, *supra* note 14, at 522-23.

The tax laws of the United States also seem to recognize that variation margin payments are actual payments on the contract to reflect changes in the value of the commodity therein; that is, the parties are taxed on losses or gains even if the contract does not close. 26 U.S.C. § 1256 (tax rules for contracts marked to market); S. REP. No. 144, 97th Cong., 2d Sess. 156 (1981). Under constitutional principles, a tax payer cannot be taxed on gains which he does not actually realize. *See* Eisner v. Macomber, 52 U.S. 189 (1920) (stock dividend not realized income; therefore nontaxable). Thus, because variation payments are taxed as they are made, it would seem, under the constitutional principle, that margin payments are being made in satisfaction of the purchase price of the contract as well as serving as a good faith deposit.

The bankruptcy code also recognizes that these payments are made as a part of the debt incurred in a commodity futures contract. The code provides that a margin payment is for value; that is, it is a payment for a present or antecedent debt and not simply a "security" or a good faith deposit. 11 U.S.C. § 548(d)(2)(B).

495. *See generally* M. MAYER, MARKETS WHO PLAY . . . WHO RISKS . . . WHO GAINS . . . WHO LOSES . . . 289-290 (1988).

496. *But see id.* at XXIV. Of course, a hedger may actually own the underlying commodity that is being hedged. *See* 17 C.F.R. § 1.3(z) (CFTC definition of hedging). *See generally* CFTC, *Clarification of Certain Aspects of The Hedging Definition*, [1986-1987 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 23,713 (1987) (hedging often used by commodities producers); *Report of the CFTC Financial Products Advisory Committee, The Hedging Definition And The Use of Futures and Options: Problems And Recomendations For Reform* (June, 1987). The exchange, however, still needs a deposit to assure performance, because it cannot monitor whether the hedger is maintaining that position at all times.

Another frequent claim is that securities margin is a limitation on credit, while futures margin is not credit-based, but is a good faith deposit.[497] This too may not be as great a conceptual distinction as the exchanges claim. A large trader in futures will pay a price for the commodity that reflects the carrying costs of the commodity until delivery date. This "contango" reflects an interest cost on the purchase price of the commodity.[498] Therefore, a futures contract is inherently a credit transaction in that the seller is in effect paid the interest cost of the commodity until delivery date.[499] Moreover, hedgers may borrow to pay the variation margin on their commodities, or may forego other investment opportunities on which they could earn interest. Of course, the parallel between futures and securities margins is still far from perfect in that the credit aspects of a futures transaction are less apparent, and futures margins may not have the same overall credit effects as securities margins.[500]

In any event, these distinctions may be pointless in reaching a policy decision on whether regulation is needed. So what if one type of margin is a down payment and the other a good faith deposit? So what if one type of margin has a credit function and the other does not? What difference do such distinctions make in determining whether margins will reduce market volatility or guard against systemic risks? Therefore, the argument that there are inherent conceptual differences between securities and futures margin simply may not add much to the resolution of the question of whether commodity futures margins should be subject to federal regulatory control.

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497. M. MAYER, *supra* note 495, at XXIV.

498. Contango has been defined as a market situation where "prices are progressively higher in the future delivery months than in the nearest delivery month. H.R. REP. NO. 850, 95th Cong., 2d Sess. 116 (1978). This occurs in a carrying charge market. Carrying charges are the cost of storing the physical commodity, as well as insurance, interest on the investment and other incidental costs, over the life of the futures contract. It is a "carrying charge" market when higher futures prices occur for later maturing futures contracts. If the carrying charge is adequate to reimburse the holder of the futures contract for the carrying costs, it is called a full carrying charge market. *Id.* at 121-23. *See also* STOCK EXCHANGE PRACTICES, *supra* note 58, at 6453 (discusses use of contango in stock market loans).

499. In addition, hedgers must borrow or incur the cost of funds to pay variation margin calls on the position. For that reason, the *FTC Study* stated that hedging transactions involve the same employment of credit as did securities transactions even though it is not possible to make an investment in a grain futures contract in the same way that an investment is made in a stock. FTC STUDY, *supra* note 9, at 5-7, 20. *See generally* Karmel, *Securities Industry Self-Regulation - Tested By The Crash*, 45 WASH. & LEE L. REV. 1297, 1317-18 (1988).

500. The Federal Reserve Board also has found that the differences between commodity margins and securities margins are less than critical. The *Reserve Board Study* stated that:

> In the first place, margins are also performance bonds, as are the margins that have long been required of those selling stocks short. These margins are subject to federal regulation, and a need to coordinate them with margin on securities purchase has long been recognized. Second, that one type of margin involves credit and one may not would appear to have major relevance only if the sole objective to federal regulation were to control the 'diversion of credit.' [H]owever, federal regulation has had other goals, and these are concerned with controlling the degree of leverage obtainable by participants rather than with securities credit *per se*.

RESERVE BOARD STUDY, *supra* note 30, at 17.

3. The Self-Protection Argument Has Much Merit

The strongest argument against federal controls on margin is that it deprives the exchanges of the ability to protect themselves, their members, and customers.[501] Futures customers are in a relatively perilous position, and they have no SIPC protection.[502] Although such protection was considered when the CFTC was created, Congress determined that the CFTC should first study and report on whether there was a need for legislation that would insure commodity futures account owners.[503] The CFTC conducted a brief study comparing the losses in commodity accounts to losses in accounts that were covered by government insurance programs, such as SIPC and the FDIC, among others. The study found that commodity account losses were substantially lower than those in the government insured programs.[504] The CFTC determined from this cost-benefit analysis that government insurance protection was not cost-effective for commodity futures accounts and that there was no need for legislative action.[505] This was a startling conclusion in view of the fact that commodity accounts are subject to high leverage, intense market volatility, and, at least as was earlier claimed by the CEA, the widespread existence of undercapitalized customers.

The reason for the better performance of the commodity market was the effectiveness of the margin system in the commodity futures industry.[506] That performance, however, faltered somewhat during a default on the Commodity Options Exchange.[507] That default caused the CFTC staff to reexamine whether government insurance was needed. It found that the default was caused by the low costs of acquiring short options positions, which were margined in the same manner as short futures positions, and that the positions were heavily concentrated in an undercapitalized firm.[508] It also found that customer margin funds with positive balances were used to pay margin obligations of other customers

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501. *See supra* notes 165-66 and accompanying text for a discussion of the exchanges' argument that the purpose of margin is the protection of the exchanges.

502. 15 U.S.C. 78fff-3 (SIPC insures only customer accounts at brokerage firms; does not insure futures trades).

503. *See* Commodity Futures Trading Commission Act of 1974, Pub. L. 93-463, § 417, 88 Stat. 1389 (1974) (codified in scattered sections of 7 U.S.C.). The Act reads, in part:

> The Commodity Futures Trading Commission shall submit to the Congress, not later than June 30, 1976, a report respecting the need for legislation insuring owners of commodity futures accounts and persons handling or clearing trades in such accounts against loss by reason of the insolvency or financial failure of a futures commission merchant carrying such accounts. The report shall contain the recommendations of the Commission concerning the form and nature of any such legislation.

Id. at 1450.

504. CFTC, *Report to Congress Concerning Commodity Futures Account Insurance,* [1975-1977 Decisions] Comm. Fut. L. Rep. (CCH) 20,235 (1976).

505. *Id.*

506. *Id.*

507. *See supra* note 414 and accompanying text.

508. *See In re* Morrissey, [1986-1987 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 22,961 (1986) for a discussion of this default.

whose accounts were in default.[509]

The CFTC staff concluded in its study of that default that the existing system had mitigated the default's effect and that the guarantee of the clearinghouse had maintained market integrity. But the CFTC proposed a number of changes that would have imposed capital charges for concentrated positions. It further recommended that the CFTC have a self-regulatory organization — the National Futures Association — conduct a further study to determine whether there should be a federal insurance program. The ultimate result, however, was that the CFTC determined that it would not seek legislation for account insurance.[510] This judgment seems to have been validated by the fact that there were no significant failures in the commodity futures industry during the stock market crashes of 1987 and 1989. Indeed, market failures, at least in 1987, seemed to have been greater on the securities side of the market.[511]

Related to the need for self protection is a need for the exchanges to have flexibility in raising and lowering margins to meet volatile market conditions that may change by the hour or by the minute. It is unlikely that the government would or could ever respond to market volatility as quickly as the exchanges. Government meetings must be called, personnel gathered, the situation studied, and deliberations and staff studies considered and reviewed. Even then the decision will be made by people who are unfamiliar with the markets daily operations. It would seem unfair to saddle the exchanges with that kind of delay and uncertainty. The exchanges have margin committees that are intimately familiar with the marketplace. They know the marketplace, and they can act swiftly to make margin changes that reflect the realities of what is occurring in the marketplace in terms of price volatility.

Moreover, even if the government could act swiftly to increase margin requirements during a market crisis, it might exacerbate the situation by placing greater stress on available credit facilities. Increased margin requirements will mean an increased need for cash or cash equivalents. That, in turn, could cause or worsen a liquidity problem similar to that which the exchanges encountered during the stock market crash of 1987.[512] Further, it is unlikely that the govern-

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509. *Id.*

510. *Report of the CFTC Division of Trading and Markets on Volume Investors Corporation* (July, 1985). The CFTC obtained the opinion of the Federal Deposit Insurance Corporation that individual customer funds held in segregated customer bank accounts would be protected by FDIC insurance on an individual basis in the event of a bank failure, even if all customer funds of a brokerage firm were held in a single account at the bank. Letter from Roger A. Hood, Assistant General Counsel, Federal Deposit Insurance Corporation, to Andrea M. Corcoran, Director, CFTC Division of Trading and Markets (July 23, 1984), *reprinted in CFTC Interpretive Letter No. 84-14,* [1984-1986 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 22,311 (1984).

511. *See supra* notes 433-40 and accompanying text for a discussion of the crash. The Brady Commission Report stated that "[d]espite low margin requirements, the financial performance control aspect of futures margins has operated in a sound and effective manner on an intramarket basis." BRADY REPORT, *supra* note 361, at 64. *But see Chicago Exchanges, supra* note 247 (exchanges step in to cover customer losses in the bankruptcy of a futures commodity merchant).

512. Increasing margin requirements in a rising market could have the effect of requiring short traders to close out their contracts. Hon. N. Smith, M.C., *Commodity Futures Trading,* 25 DRAKE

ment could act swiftly to lower margin requirements to alleviate credit strains in a falling market. It goes entirely against the grain of the government to ease regulation, particularly on short notice.[513]

It also seems that the commodity futures margin system — with a few exceptions — has proved to provide adequate financial controls for systemic performance.[514] This makes a strong case for the maxim: "If it ain't broke, don't fix it." But, if margin controls are still thought to be necessary, the burden is on the proponents to show that government controls will be more effective in preventing catastrophic failures that have yet to occur! It is not clear how that burden can be met. Assuming that it is, the government will become the caretaker of the financial integrity of the futures market; then the argument will be made that government account insurance is also necessary in the event that government controls are not successful. Traditionally, if the government assumes the responsibility for regulating the financial integrity of an industry, it also assumes the losses.[515] This is particularly appropriate if the government removes the ability of the exchanges and the industry to protect themselves. In the aftermath of the truly incredible financial drain on the Federal Savings and Loan Insurance Corporation resulting from the savings and loan debacle, the significant drains on the FDIC from bank failures, and the significant losses borne by SIPC over the years, the creation of a new government insurance program is unlikely to be very popular.[516]

B. Arguments in Favor of Increased Regulation

The arguments in favor of federal margin authority over futures seem to break down into the following categories:

L. REV. 1, 15 (1975). This would in turn place increased demand on the buy side of the market because these traders must buy offsetting contracts in order to close out their positions. *Id.*

513. The Chairman of the CFTC has argued that government is not well equipped to adjust margin on a daily basis, as is often required in the futures markets. She noted that, in 1987, the Chicago Board of Trade changed margin levels over 200 times. The Chairman asserted that no government agency could meet such requirements. *Regulatory Jurisdiction: What Motivates The Call For Reform?, Address of Wendy Gramm, Chairman of the CFTC Before the CFTC/Futures Industry Institute Conference*, May 2, 1990 at 6 [hereinafter *Gramm Address*].

514. One notable exception to the favorable market performance of the commodity futures trading system arose in the so-called "salad oil" scandal in the 1960s. There, an enormous swindle by a company trading in commodity futures contracts caused the New York Produce Exchange to fail. *See generally* N. MILLER, THE GREAT SALAD OIL SWINDLE (1965). *See also* Miller v. New York Produce Exchange, 550 F.2d 762 (2d Cir. 1977) (defaults from salad oil swindle); *In re* Ira Haupt & Co., 234 F. Supp. 167 (S.D.N.Y. 1964) (same), *aff'd*, 343 F.2d 726 (2d Cir.), *cert. denied*, 382 U.S. 890 (1965). The salad oil swindle raised concerns about margin requirements because fraudulent warehouse receipts had been used for margin deposits. Note, *supra* note 151, at 714 n.117. More recently, the collapse of a commodity futures brokerage firm in Chicago has raised concern that the CFTC's rule governing the treatment of customer funds may need strengthening. *See generally Stotler Collapse Prompts CFTC to Review Rules*, Wall St. J., Aug. 29, 1990 at C13, col. 1.

515. *See, e.g.*, Gleckman & Yang, *The Road to Bank Failure is Paved With Federal Deposit Insurance*, Business Week, July 16, 1990, at 152; *Financial Fracas, S&L Mess May Spark a Thorough Overhaul of Deposit Insurance*, Wall St. J., July 3, 1990, at A1, col. 6.

516. *Id.*

(1) Low margin encourages speculators, whose trading accentuates price swings upward as they are attracted to the market and downward when they liquidate as prices decrease.[517]
(2) Lower futures margins divert volume and liquidity to the futures markets.[518]
(3) Under some circumstances, as in the case of the Silver Crisis of 1980 and the Stock Market Crash of 1987, futures margins may create credit problems in the national economy.[519]
(4) Margin can be used to control or reduce market volatility.[520]

A discussion of the merits of these arguments follows.

1. Low Margins Do Not Appear to Encourage Undue Speculation by Speculators

The claim that greater leverage tends to attract speculators, who destabilize the markets, does not seem to be supported by the facts. It is true that, historically, small undercapitalized traders in the futures markets caused undue price swings. But the nature of the markets have changed. A survey in the 1930s showed that some of the largest groups of traders were housewives, tradesmen, unemployed persons, lawyers, and doctors.[521] Today, that market composition has shifted drastically. Institutional traders now account for the majority of securities-related futures traders.[522]

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517. COMMODITY EXCHANGE AUTHORITY, U.S. DEP'T. OF AGRICULTURE, REPORT BY THE ADMINISTRATOR OF THE COMMODITY EXCHANGE AUTHORITY 4 (1949); BRADY REPORT, *supra* note 361, at 65. *See generally*, Coffee, *Epilogue: The Use and Abuse of Finance Theory in Securities Law: A Primer for the Perplexed*, I ABA GLOBAL SECURITIES MARKETS AND THE DISTRIBUTION OF SECURITIES, 398, 401 (1991) (higher margins may discourage "noise" traders who introduce errors into the order flow because they trade without information).

518. *See* OCTOBER 1987 MARKET BREAK, *supra* note 20, at xv.

519. *See supra* notes 198-232 and accompanying text for a discussion of the Silver Crisis; *supra* notes 433-39 for a discussion of the Stock Market Crash of 1987.

520. *See* OCTOBER 1987 MARKET BREAK, *supra* note 20, at xv (low margins result in greater price volatility). *See also supra* note 462 for a discussion of the SEC Chairman's position that increased margins would control market volatility.

521. 80 CONG. REC. 8289-8293 (1936); Campbell, *Trading in Futures Under the Commodity Exchange Act*, 26 GEO. WASH. L. REV. 215, 220 n.20 (1958); (citing Bagnell, *Analysis of Open Committments in Wheat and Corn Futures on The Chicago Board of Trade*, U.S.D.A. Circular No. 397 at 8, 16 (Sept. 29, 1934)).

522. *Futures Shock*, *supra* note 488. The role played by institutional investors can clearly be seen through the trading that was conducted during the stock market crash of 1987. On one day, in the last half hour of trading, a few portfolio insurers sold over 6,000 futures contracts, equal to over $660 million of stock. BRADY REPORT, *supra* note 361, at 36. The four largest sellers accounted for $2.85 billion in trades, or 14 percent of total sales during one period of this crash. *Id*. Mutual funds also sold some $900 million worth of stocks and futures, and three portfolio insurers sold approximately $2 billion, or about two percent of the New York Stock Exchange sales on one day. *Id*. Portfolio insurers sold the equivalent of $4 billion worth of stocks. *Id*.

The Chairman of the CFTC has stated that individuals have not been diverted from the stock markets because of futures trading. Rather, participation in the stock market by individuals has been declining since the 1960s. Today individual investors are represented in the market through institutions such as pension funds, mutual funds and pools. *Gramm Address*, *supra* note 513, at 4.

Moreover, speculators have not been responsible for market disturbances in recent years, either by their influx into the market during market booms or through forced liquidations. Indeed, retail or individual customers' accounts constitute only about five percent of the traders in the largest futures index contract market, the focus of the SEC's concern.[523] It was institutional investors, with virtually unlimited resources, that played the critical role in the markets during the stock market crash in October, 1987. As the Brady Commission noted, throughout the stock market crash "trading activity was concentrated in the hands of a surprisingly few institutions" who "played the dominant role during this tumultuous period."[524] As already noted, it does not appear that higher margin requirements would deter those institutions.[525]

2. Liquidity Diversion Claims Do Not Justify a Need for Federal Controls

The argument that futures margins divert volume, liquidity and price discovery from the securities markets because of the absence of governmentally-required higher margins does not present a strong case for federal margin control. The futures markets have proved to be more liquid and more efficient than the stock markets.[526] The commodity futures industry should not be handicapped to become equal in inefficiency with the securities markets. As noted above, the Federal Reserve Board and the Treasury suggested that margins in the securities industry are higher than that necessary to provide performance assurance.[527] The Treasury earlier suggested that affirmative federal regulation of securities margins be discontinued.[528]

Additional unnecessary regulation should not be imposed simply for the purpose of correcting a disparity in competition caused by existing unnecessary regulation. The better way to level the playing field is simply to do away with the latter. If that is done, the self-regulatory organizations can work together to set margin levels that are neither excessively high nor destructively low. This will still present a danger, however, that margin levels will become a matter of

523. *Futures Shock*, *supra* note 488. *But see* Gottschalk, *Nysex Margins Under Secretary*, J. Comm (Spec. rep.), March 13, 1991, at 2C, col. 4 (oil future between say low margin have increased price volatility).

524. BRADY REPORT, *supra* note 361, at 15. Another study has noted that: "Institutional investors now are the dominant users of U.S. financial markets in terms of trading on exchanges, ownership of equity ownership, and total assets invested in equities." BULLS AND BEARS, *supra* note 361, at 32.

525. One study noted that large increases in margin requirements may result in increased trading in lower priced, more speculative, securities. BOGEN & KROOSS, *supra* note 272, at 123.

526. *See* OCTOBER 1987 MARKET BREAK, *supra* note 20, at xiv, 1-1, 3-5, and 3-6.

527. *See supra* notes 375-79 and accompanying text for a discussion of the Federal Reserve Board's position on margin and stock price volatility.

528. *See supra* note 379 for the Treasury's views. One author has even suggested that margin regulations for securities contracts are "useless" in light of the changing nature of the securities markets. Note, *supra* note 151, at 706-07 (1989). There has been a decrease in the amount of credit used to purchase securities. *Id.* at 706.

competition among the exchanges. This is a legitimate matter of concern to the government.

3. Systemic Risk Concerns Are Legitimate, but Pose Other Dangers

The concern about systemic risks has perhaps the greatest appeal as an argument for at least residual federal regulatory control over futures margins. The stock market crash of 1987 presented the specter of a liquidity crisis that required the intervention of the Federal Reserve Board. At that time, the government's credit and resources were called into play.[529] Similarly, the Federal Reserve Board had to act during the silver crisis of 1980, by curbing speculative credit and supporting the banking system so that the Hunts' default would not threaten the financial markets.[530] It would seem that the government, therefore, has some basis to assert that it be given residual authority to assure adequate protection of the credit system that it is called upon to support.[531] The concern that margins not be used for competitive purposes also supports the argument for at least residual authority on the part of the government, particularly if securities margins are deregulated.

It seems that such residual authority could safely be given to the Federal Reserve Board. The Board has demonstrated through the years that it is not a fanatic on margin and that it will not act irresponsibly by imposing unrealistic margin levels.[532] Indeed, the thinking it has revealed in recent years — namely, that its role simply should be a residual one — is a practical approach. That attitude, particularly if codified, should assure the commodity exchanges that their interests will not be threatened. At the same time, residual authority would provide a safeguard against systemic risks that the Federal Reserve Board may rightfully fear, in light of prior market events.

The residual role that the Federal Reserve Board advocates would be in keeping with the concept of self-regulation in both the commodity and securities industries. Self-regulation envisions that the exchanges will regulate in the first instance and that the government's role will be one of residual oversight; that is, the government will keep the shotgun behind the door.[533] An elaborate self-regulatory system has been developed in the securities industries. For example,

529. OCTOBER 1987 MARKET BREAK, *supra* note 20, at 5-12, 5-13. The transfer of margin funds caused by the massive trading during the stock market crash of 1987 is illustrative of the concerns of the Federal Reserve Board. On October 16, 1987 approximately $944 million in commodity margin calls were issued, and over $11 billion in margin calls were sent out over the next four trading days. On October 19, 1987, alone, $3.6 billion in new margin was requested, and on the three succeeding days an additional $8 billion was demanded. *Id.* at 5-13.

530. *See supra* note 198-201 and accompanying text for a discussion of the Hunts role in the silver crisis.

531. It should be noted, however, that during the stock market crash of 1987, no investor lost money from stock index futures contracts due to defaults. *Harmonizing Margins*, *supra* note 325, at 873.

532. *See supra* notes 373-77, and 464-67 for a discussion of the board's views.

533. As stated by Supreme Court Justice William O. Douglas, a former SEC Chairman, the exchanges are to "take the leadership with Government playing a residual role. Government would keep the shotgun, so to speak, behind the door, loaded, well oiled, cleaned, ready for use but with the

the National Association of Securities Dealers, Inc. regulates over-the-counter trading.[534] It has a vast network of staff and membership participation to enforce its rules. These rules impose standards as high or higher than those found in the federal securities laws. The securities and stock options exchanges also have strong self-regulatory organizations with elaborate surveillance procedures and disciplinary enforcement.[535]

Similarly, the commodity exchanges are required by law to enforce their rules, which must be approved by the CFTC.[536] They maintain continuous surveillance of the markets and bring disciplinary actions against brokers who do not meet their standards.[537] There have been breakdowns in the self-regulatory role of both the security[538] and commodity exchanges.[539] But the commodity exchanges have generally performed notably in maintaining the financial integrity of the futures markets through their margin regulations.

There are dangers, however, in allowing the Federal Reserve Board to have residual authority over margins. If a catastrophe occurs, the Federal Reserve Board will be singled out as the agency responsible. It will then become necessary for the government to commence a bail-out, which might cost untold billions of dollars and present the possibility of another debacle such as that seen in the savings and loans industry. To avoid such a danger, the Federal Reserve Board may pressure the exchanges to set margin levels higher than is necessary for market efficiency. In that event, market liquidity and efficiency will be unnecessarily impaired. Moreover, the discipline of the marketplace, which has governed margin requirements for over 120 years, will be relaxed; this is so because the exchanges will lose interest in maintaining day-to-day control over margins, if they are set at a level that is above what the exchanges believe necessary. A deterioration of the exchanges' "feel" for the market and a constant monitoring of margin changes will then result, and the system will become more and more dependent on the judgment of the Federal Reserve Board. But that

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hope it would never have to be used." W. DOUGLAS, DEMOCRACY AND FINANCE 82 (Allen ed. 1940).

534. *See generally* 2 LOSS, *supra* note 123, ch. 8C, at 1359-91.

535. *See* Cary, *Self-Regulation in the Securities Industry*, 49 A.B.A. J. 244 (1963); Karmel, *supra* note 499 (self-regulation before, during, and after the October 1989 market crisis).

536. *See* 7 U.S.C. § 7a (duties of contract markets).

537. *See generally* Nachbar, *Contract Market Self-Regulation Under The Commodity Exchange Act*, 31 CLEV. ST. L. REV. 573 (1982) (exchange disciplinary procedures).

538. SPECIAL STUDY, *supra* note 283, pt. 4, at 573-74 (self-regulation failure in supervision of branch offices, regulation of odd-lot trading, regulation of specialists, investigation of public complaints concerning Exchange's number firms, and discipline for ethical standard violations), 751-813 (SEC, STAFF REPORT ON ORGANIZATION, MANAGEMENT, AND REGULATION OF CONDUCT OF MEMBERS OF THE AMERICAN STOCK EXCHANGE (1962)); H.R. REP. NO. 1519, 92d Cong., 2d Sess. 92 (1972) (1962 SEC Study of American Stock exchange when cooperative regulation broke down); S. REP. NO. 865, 93d Cong., 2d Sess. 2 (1974) (SEC languor in face of change); SPECIAL STUDY OF THE OPTIONS MARKETS, *supra* note 335, ch. VI, at 487-614 (self-regulatory oversight of retail firms and their associated persons).

539. *See* H.R. REP. NO. 975, 93d Cong., 2d Sess. 38 (1974) (self-regulatory attempts failed); S. REP. NO. 1131, 93d Cong. 2d Sess. 19 (1974) (need for better regulation to oversee expanding, complex futures market).

agency is too far removed from the marketplace to effectively determine the delicate balance between margin levels high enough for adequate systemic protection and those low enough for maximum market efficiency. Therefore, Congress should act very carefully in imposing any such role and allow the exchanges to maintain their front line combat ability to change margin requirements rapidly as market conditions dictate.

4. Market Volatility Has Not Been Shown to Be the Result of Low Futures Margins

Decreasing market volatility will require a more affirmative regulatory role than that envisioned by the Federal Reserve Board. The SEC, and presumably the Treasury Department, believe that the futures markets have increased volatility in the stock markets, as evidenced by the sharp market reactions in 1987 and 1989. They believe that this volatility could be reduced by curtailing "rampant" speculation in the futures markets through the imposition of higher futures margins.[540]

The Federal Reserve Board has not accepted these claims, which appear to contain several fallacies. First, institutional traders now dominate the futures markets and are unlikely to be deterred by increased margin requirements. Second, there is a serious question about how this margin authority would be used to lessen market volatility. If margin levels are raised only during times of volatility, the result may be the opposite of what is desired. Assuming that increased margins will discourage trading activity, and if the securities markets are in fact driven by futures speculation rather than fundamental factors,[541] the result may very well be the drying up of market liquidity, which could cause an even worse market break.[542] The experience in the silver market in 1980 supports this con-

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540. *SEC Chief Accuses CFTC of Distortion in Mini-Crash Probe*, Wall St. J., June 29, 1990, at C16, col. 6. The SEC Chairman also stated that:

> In 1987 and 1989, we entered a market crisis with many of the margins in stock index futures as low as 2.2%. And to say - as did some in the futures and regulatory communities - that a system that produces 97.8% leverage is adequately strong is flat wrong.
>
> . . . The problem with having the 98% leverage is that if the market falls 200 or 500 points, you then find yourself in the midst of a crisis, making margin calls and raising margin requirements. That sucks liquidity out of the market place. And the worst time to be sucking liquidity out is in the midst of a precipitous fall in the market. And, yet, twice we have been in that position . . . . But the impact of having set the margin too low at the outset is that you are playing catch-up ball in the midst of a crisis. That undermines the stability that we could otherwise have.

Barron's, May 28, 1990, at 14, 28.

541. *See infra* notes 547-49 for a discussion of some of these fundamental factors.

542. As an author has stated:

> An important reason for not granting margin control for the purpose of preventing price excesses is that it would not work. Suppose that a speculative boom gets started and grows on what it feeds on and that the controlling authority recognizes the rise as a price excess. He imposes higher margins. The longs will not have any trouble; they already have profits and experience no difficulty. The shorts will have difficulty since they have losses; it is their capital position that is extended. An increase in margin requirements would force them to buy in short positions, lending further upward impetus to prices. Long speculators do not

cern. There, margin requirements were raised to astronomical levels and severe trading restrictions were imposed on large traders. The effect was a free fall in market prices.[543]

It may be that the effort to obtain federal margin control is directed only at increasing margin levels before a market becomes overheated so that a boom will be avoided. In that regard, the SEC Chairman has suggested that commodity exchange margin levels of at least twenty percent would serve as a national speed limit, which he believes will prevent the development of a market break such as those in 1987 and 1989.[544] But the SEC Chairman has not articulated how this speed limit will achieve this goal, and he has ignored the role that institutions play in the market. Institutions may simply choose to put up more Treasury bills. The SEC's position, therefore, seems to be based more on subjective opinion than hard facts. It also appears to be based upon a vague notion that margin and market volatility are inherently related. That may very well have been the case in the 1920s, but the Federal Reserve Board has not found that theory to be correct in modern markets.[545]

It seems that before such a price control course is adopted by Congress, there should be much further study on how to use such a mechanism. The market crises of concern to the SEC have been rapid and short-lived. In none of those crises does it appear that federal margin authority would have had any effect other than to accentuate an already serious problem. Further, margin levels for securities themselves must be examined. The high stock margins imposed on securities has not stopped the stock market from reaching record levels. The stock market has undergone a major expansion over the last several years, and stock price levels have reached unprecedented heights.[546] If the mar-

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> mind larger margins in rising markets; the shorts do. The thinking of the people who proposed governmental control of margin requirements has long since been intriguing.

T. Hieronymus, *supra* note 12, at 321. *See also* Dunne, *Margin Requirements - Next to Go?*, 98 Banking L.J. 299, 299 (1981) ("In terms of defense against another 1929 debacle, margin requirements may well be analogized to the type of defense immortalized by the name of the sometime defense minister of the Third Republic, Andre Maginot").

543. *See supra* note 198-224 and accompanying text for a discussion of the silver crisis of 1980.

544. *Gramm Address*, *supra* note 513, at 6-7. The Chairman of the CFTC has criticized the concept of having a so-called national speed limit such as a minimum of 20% margin for stock index futures contracts, as suggested by the SEC Chairman. She stated that this could drive futures trading offshore. *Id. See generally A Future For The Futures*, Newsweek, July 23, 1990.

545. Two authors have stated that:

> Though margins do impose costs on traders, the effect of margin changes on volume is difficult to measure and there is no evidence of a systematic relation between different margin levels and the proportion of trading by speculators. Even if low margins encourage speculative trading, there is no empirical support for the view that speculators raise price volatility, and theoretical reasoning supports the view that speculators provide liquidity to markets. Recent evidence, although limited, suggests that higher margins for stock index futures are not associated with lower price volatility in futures markets.

Harmonizing Margins, *supra* note 325, at 901.

546. The Dow Jones Industrial Average has been at historically high levels since before the stock market crash of 1987. CFTC 1989 Crash Report, *supra* note 459, at 10-11; Strauss & Wiseman, *The Dow Backs Off; 56.44 Point Dive Ends 3000 Quest*, USA Today, July 24, 1990, Money Section, at 1 (Dow drops 56 points; fails to break 3000 mark).

ket is indeed in a boom, the high margin requirement for securities has not stopped that boom. It also does not appear that margin levels were what caused the market breaks of 1987 and 1989 that are now of so much concern to the SEC. The Brady Commission attributed the market break in October of 1987 to fundamental factors, which were also the basis for the market break in 1989.[547]

There are more appropriate mechanisms for controlling unwanted volatility than margin restrictions that seek to price participants out of the market place. The Brady Commission, among others, viewed so-called "circuit breakers" as measures that could be useful.[548] These circuit breakers would include trading suspensions, price limits, and position limits.[549] Careful surveillance and tightened prohibitions against manipulation and fraudulent practices would also be useful. For example, more stringent position limits could be used to restrict the size of positions of large hedgers and institutions, which could effect market volatility unduly.[550] Position limits could also be used to impose limitations on

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547. BRADY REPORT, *supra* note 361, at 15. The *Brady Report* concluded that the fundamental factors causing the revaluation of stock prices during the stock market crash of 1987 were an announcement that the August, 1987 merchandise trade deficit was larger than anticipated and the announcement of a House Ways and Means Committee proposal to eliminate tax benefits associated with the financing of corporate takeovers. *Id.* The market break of 1989 was said to be due to negative economic news and to the fact that a United Airlines merger fell through. *SEC Division of Market Regulation, Trading, An Analysis of October 13 and 16, 1989* (1990); CFTC 1989 CRASH REPORT, *supra* note 459, at 14. Recently, a congressional staff report concluded that whether federal margin contracts would be effective in controlling stock market volatility is uncertain. BULLS AND BEARS, *supra* note 361, at 16. Further, "empirical studies of the relationship between futures margin levels and stock market volatility reach conflicting findings and are in the aggregate inconclusive." *Id.* at 86.

548. BRADY REPORT, *supra* note 361, at 66-67.

549. *Id.* at 66. Some circuit breakers have been adopted by the commodity and security exchanges, but they have met with mixed reviews. CFTC 1989 CRASH REPORT, *supra* note 459, at 5-7; [1990 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 84,612 (Aug. 1, 1990) (letter from U.S. General Accounting Office assessing SEC and CFTC reports on effects of circuit breakers during October 13, 1989 market break); *Safer Than It Looks*, THE ECONOMIST, Aug. 4, 1990, at 63 (circuit breakers unnecessary and misguided); *Volatile Reactions*, THE ECONOMIST, July 21, 1990 at 22 ("At worst, these circuit-breakers can compound a trading panic. At best, they drive business into freer centres, such as London. They fail to tackle what lies at the heart of the malaise."); Salwen & Torres, *Tighter Rein, New Securities Rules From Big Board,* Feds Are Altering Market, Wall St. J., Nov. 8, 1990, at 1, col. 1 (discussion of adverse market effects of circuit breakers); *Regulators View Market's Steep Descent Also As Example of Controls That Work*, Wall St. J., Aug. 27, 1990, at C15, col. 1 (positive role of circuit breakers); Anders, *Circuit Breakers Help Keep Order in Market Rout*, Wall St. J., Aug. 7, 1990, at C1, col. 6 (mixed review of circuit breakers); Salwen, *Senate Approves Broader Power for SEC To Gather Date, Shut Down Market*, Wall St. J., Aug. 6, 1990, at C14, col. 6 (same); Lux, *Placebo, Can Circuit Breakers Heal an Ailing Market*, Investment Dealers' Dig., Aug. 6, 1990, at 14 (circuit breakers may give false sense of security); Salwen, Shapiro, *Circuit Breakers: Maybe They Work, Maybe They Don't*, N.Y. Times, July 28, 1990, at F7, col. 1 (mixed reviews on circuit breakers); Shapiro, *Circuit Breakers Help Index Futures Recover*, N.Y. Times, July 24, 1990, at D6, col. 1 (positive role of circuit breakers); *Circuit Breakers Endorsed By Panel Despite Questions*, Investment Dealers' Dig., June 18, 1990, at 12 (same); Furbush, *Stock Bashing Program Trading*, Wall St. J., June 14, 1990, at A14, col. 3. (circuit-breakers at one exchange caused volume to migrate to other exchanges which do not have similarly coordinated circuit-breakers).

550. The Commodity Exchange Act, since its adoption in 1936, has sought to prevent dramatic price changes by limiting the size of speculative positions of traders. 7 U.S.C. § 6a.

the volume of trading that could be done in one day, thereby assuring an orderly market.[551] Similarly, price limits may be used to require a trading halt when prices exceed specified levels. Such limits are common in the futures markets. They allow the parties a pause to assess information and to obtain the funds necessary to meet their margin calls.[552] The SEC has been given power to take emergency action in the case of market crises such as those of 1987 and 1989.[553] This would include the power to stop trading or to call a brief trading halt. In addition, strengthening of clearing mechanisms and the imposition of cross-margining among the securities options exchanges and the commodity exchanges is being studied as a means of reducing liquidity demands.[554] All of these proposals seem to have more viability than do efforts to impose margin restrictions.

To illustrate, during the stock market crash of 1987, much of the chaos in the market arose because traders in the futures markets and the options exchanges could not determine what stocks on the New York Stock Exchange were open for trading. This was critical because stock index values are based on the values of the underlying stocks comprising the index.[555] Across-the-board trading halts would have been useful to allow the situation to be assessed and order flows to be handled in a more orderly fashion. Such trading halts would have also allowed participants greater opportunity to arrange needed margin funds, which might have averted the Federal Reserve Board's concern with the liquidity problems that occurred.

The market in general could have profited from temporary trading halts; for example, had there been time for traders to assess market fundamentals, panic selling or market mania might have been replaced by more informed and reasoned decisionmaking. The exchanges and self-regulatory bodies also could

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551. *See SEC Approves Rule Curtailing Program Trades*, Wall St. J., July 26, 1990, at C1, col. 3 (plan targets index arbitrage); *Curb on Some Program Trades to Be Tried*, N.Y. Times, July 26, 1990, at D8, col. 3; *Steps Urged to End Huge Market Swings*, Wash. Post, June 13, 1990, at B1 (blue-ribbon panel of American business recommends temporary trading halts). The CFTC has the authority to impose restrictions on the amount of trading volume that traders can engage in during a given day. 7 U.S.C. § 6a. At an early point in its history, however, the CFTC eliminated those limits after an advisory committee concluded that they were not effective. *Elimination of Daily Speculative Trading Limits*, [1977-1980 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 20,756 (Feb. 6, 1979); *Proposed Elimination of Daily Trading Limits*, [1977-1980 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 20,669 (Sept. 22, 1978).

552. Letter from John M. Damgard, President, Futures Industry Association to Nicholas Brady (Dec. 15, 1987).

553. *See* Market Reform Act of 1990, Pub. L. No. 101-550, § 2, 104 Stat. 963 (1990) (current version codified at 15 U.S.C. § 781(k)).

554. *Supra* notes 424-32 and accompanying text for a discussion of cross-margining. *See generally* [1986-1987 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 23,462 (Feb. 10, 1987) (CFTC proposed rule to permit cross-margining of commodity futures, commodity options, and securities options); 50 Fed. Reg. 5341 (Feb. 7, 1985) (SEC approved Options Clearing Corporation's proposed rule change authorizing funding of Intermarket Clearing Corporation to clear transactions); *Aftermath of the Crash*, *supra* note 428, at 26-28; OCTOBER 1987 MARKET BREAK, *supra* note 20, at 10-57 (Division of Market Regulation reviewing ICC and OCC cross-margining proposal); BRADY REPORT, *supra* note 361, at 65-66 (cross-margining recommended to permit market participant with investment in futures to receive credit for offsetting stocks or options investment).

555. BRADY REPORT, *supra* note 361, at 40.

have used that opportunity to speak to traders and to ensure that traders were not using program trading and other trading strategies in any way that could unduly affect the market or result in more disorderly trading. But those mechanisms simply were not available to the securities exchanges or to the SEC. In addition, there was no coordination between the regulatory bodies — namely the SEC, the CFTC, and the Federal Reserve Board during the stock market crash of 1987.[556] Coordinated trading halts and joint action might have been a more effective approach to the market break.

CONCLUSION

Financial futures contracts have become explosively popular in recent years. These instruments have changed the structure of the futures industry. Initially, the industry was based almost exclusively on traditional agricultural products, such as wheat, corn, potatoes, and eggs. Now, a majority of the futures contracts traded are financial futures contracts.[557] These products have brought a massive influx of trading interest into the futures markets. That inflow and the creation of new trading strategies, such as index arbitrages[558] program trading,[559] and portfolio insurance,[560] have resulted in soaring trading volumes.[561] This in turn has increased the visibility of the futures markets, particularly after the stock market crash of 1987.[562] It has also raised the level of congressional concern over federal regulatory control of futures margins.[563] Stock market volatility in recent years and the sharp market corrections in 1987 and 1989 have caused federal regulators, particularly the SEC and the Department of Treasury, grave concern. But it has not been shown that lower commodity futures margins causes market volatility. Nor has it been shown that low futures margins caused the market breaks in 1987 and 1989. Rather, it seems that those market crashes were caused by fundamental factors in the se-

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556. *Id.* at 59.

557. *See* FUTURES INDUS. ASS'N, VOLUME OF FUTURES TRADING: 1960 through 1990 (financial futures contracts expanded to over 180 million contracts, contrasted with some 57 million agricultural commodity futures contracts).

558. *See supra* note 487 for a description of index arbitrage. *See generally* H. STOLL, EXPIRATION DAY EFFECTS OF STOCK INDEX OPTIONS AND FUTURES: SUMMARY AND CONCLUSIONS OF THE EMPIRACLE ANALYSIS AND EXAMINATION OF PROPOSED CHANGES IN EXPIRATION PROCEDURES 3-7 (1986).

559. The concept of program trading simply refers to computerized trading strategies. *See generally* N. KATZENBACH, AN OVERVIEW OF PROGRAM TRADING AND ITS IMPACT ON CURRENT MARKET PRACTICES 11 (1987).

560. *See generally* SEC DIVISION OF MARKET REGULATION, THE ROLE OF INDEX RELATED TRADING IN THE MARKET DECLINE ON SEPTEMBER 11, 12, 1986 5-6 (1987).

561. OCTOBER 1987 MARKET BREAK, *supra* note 20 (discussion of market growth).

562. *See generally* BRADY REPORT, *supra* note 361; OCTOBER 1987 MARKET BREAK, *supra* note 20; *CFTC Division of Economic Analysis and Division of Trading and Markets, Interim Report on Stock Index Futures and Cash Market Activity During October 1987 To The U.S. Commodity Futures Trading Commission* (1987); *CFTC Division of Trading and Markets, CFTC Follow-up Report on Financial Oversight and Stock Index Futures Markets During October 1987* (1988); *General Accounting Office, Financial Markets: Preliminary Observations on The October 1987 Crash* (1987).

563. *See supra* notes 472-76 and accompanying text for a description of congressional concerns.

curities markets, such as a breakdown in a takeover effort, trade statistics, and other factors that are unaffected by the futures markets. If anything, the futures markets have provided a form of insurance to those concerned that fundamental factors do not support high market levels. Indeed, it seems strange to even suggest to participants in the futures markets that this insurance be made less effective or that its cost be increased. On the other hand, increased margin requirements are not likely to deter the institutional investors that are increasingly dominating the markets.

In fact, increased futures margins could raise more concerns than the adoption of controls would resolve. Increased margin requirements may result in a greater liquidity crisis if margin rates are raised in a time of increased volatility, such as that experienced during the stock market crash of 1987. Then, the Federal Reserve Board had to intervene to stabilize the situation. If margin rates had been increased at that time, the only result might have been even greater uncertainty, because increased margins would have increased the demand for cash and engendered further liquidity problems. Moreover, the issue of federal margin control raises several serious questions. First, what criteria would the SEC, or any other regulatory body use to determine that price volatility was too high or that margin requirements potentially as drastic as two hundred percent would have to be imposed to force institutional traders to remove themselves from the markets? Second, what evidence is there that, if the government were to sharply increase margin requirements during a period of market volatility, the resulting effect on prices would not be more disastrous than if the matter were left to the more price neutral exchanges? Third, what is the appropriate margin level to reduce price volatility? Finally, would increased margin levels cause a cash crisis as traders scramble for additional funds to meet margin requirements?

What has not emerged from the stock market crash of 1987 or the mini-crash of 1989 is any evidence, or even strong theoretical arguments, suggesting that increased margin requirements in the futures markets would have averted or even diminished the magnitude of those crises. The burden seems to be on the proponents of increased margins to show how increased margin requirements would provide more effective regulation. This burden has not been met. Until it is, it seems that the energy expended to obtain margin control by the SEC could be better spent on achieving a coordinated regulatory scheme.

The best argument in defense of federal control over margins seems to be that such control could guard against systemic risks on a residual basis, leaving day-to-day margin controls to the exchanges. The government would use such residual authority in the event of a true liquidity crisis or marketing emergency that endangered the economy. This control could appropriately be given to the Federal Reserve Board, which has not shown any inclination to act precipitously or with undue haste when market crises arise. The granting of such authority, however, should be coordinated with a deregulation of securities margins, so that those margins would also be set by self-regulatory organizations at levels designed solely to assure performance on security purposes. This would undoubtedly mean lower margins for the securities industry. The Federal Reserve

Board's role would have to be such that the self-regulatory organizations would not be encouraged, indeed would be discouraged, from engaging in competition to an extent that margin levels become so low as to be destructive and fail to serve their required role of maintaining market integrity.[564]

In sum, these concerns all raise highly technical and complex issues that belie the approach taken by the SEC and the Department of the Treasury. These agencies seem to believe that because low levels of margin were blamed for the stock market crash of 1929, there must be a margin culprit to blame for the 1987 and 1989 crashes. Thus, they have looked no further than the commodity futures industry, which is now playing a larger role in the securities markets. The SEC and the Treasury's concerns are no doubt good faith concerns, but they fail to take into account the changing nature of the securities markets and their participants. They also fail to fully consider other alternatives that are preferable to margin regulations.

564. A reciprocal concern is that the Federal Reserve Board will use such authority to block or hinder new instruments it does not believe to be desirable. *See generally* Barker, *The Federal Reserve And Junk Bond Financing: Anomaly or Inconvenience?*, 19 PAC. L.J. 769 (1988) (Federal Reserve Regulation Junk Bond Financing); Karmel, *Applying Margin Rules To Junk Bonds*, N.Y.L.J. Feb. 20, 1986, at 1, col. 1.