Prepared for
Harvard Electricity Policy Group
Fifty-Ninth Plenary Session
Harvard Kennedy School
May 20, 2010

"TURF WARS" – AN ESSAY

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As the individual most often identified with the fact that the Commodity Futures Trading Commission ("CFTC") has "exclusive jurisdiction" to regulate almost[2] all futures contracts regardless of the nature of the underlying asset, service, event or other thing of value, I am often challenged by members of particular industries who would seem to prefer that this role should be performed by the authority with principal oversight of their routine business activities. Call it "the devil you know vs. the devil you don't" or entertain a more high-minded title, people tend to think that centralization regardless of industry is not the optimal structure for their purposes. What follows is a defense of the *status quo*.

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2 A single exception from the CFTC's exclusive regulatory jurisdiction over all futures contracts exists in the case of certain securities. The CFTC and the Securities and Exchange Commission ("SEC") *co-regulate* futures contracts involving single corporate securities or small stock indices. By reason of an agreement between the CFTC and the SEC in 1982 that was enacted into law (known as the "Shad-Johnson Accord") the CFTC has retained exclusive regulatory jurisdiction over futures contracts on broad-based stock indexes and on U.S. government securities.

Practical Considerations.

Suppose every futures contract were allocated to the agency, department or bureau that is responsible for supervising the commercial production, processing, or merchandising of the underlying "thing." There would be dozens – if not scores – of "regulators." Here is just a *partial* list of what is already the subject of futures trading:

- Grains
- Flavorings
- Fibers
- Fruits
- Industrial metals
- Precious metals
- Petroleum products
- Weather patterns
- Natural catastrophes
- Building materials
- Emissions
- Exchange-traded funds
- Government debt
- Corporate equities
- Commercial paper
- Electricity
- Interest rates
- Currencies
- Chemicals
- Livestock
- Dairy products
- Housing indexes
- Stock indexes
- Inflation indexes

Hard as they might try, uniformity of standards and requirements among the regulators would probably be impossible so that, what is allowed by one authority is prohibited by another. Compliance costs, especially in multi-product businesses, could be astronomical. (Imagine if each supermarket had to comply with rules set by every authority having oversight of a product on its shelves).

And, unlike the current regime, many industries have multiple regulators already. Some also have to deal with federal, state and local authorities with respect to the same activity. Very few know with any certainty that, if their futures trading is regulated by the "X" agency, "X" can block demands from other authorities claiming a right to participate in the oversight process since few – unlike CFTC – have formal preemption powers.

Moreover, most businesses need to hedge a variety of risks, not simply changes in the price of their predominant asset or service. They often have exposure to foreign currency risk by reason of their import or export activities. The costs of transportation loom large in many industries. And they have borrowing (interest rate) costs as well.

Regulation by Objective.

Futures contracts are *rarely* used to convey goods, services or other valuables. They occupy a parallel universe where the *real* participants can enter look-alike financial transactions to protect ("hedge") against hostile price movements. Futures contracts, in other words, are a form of *insurance* and are regulated like insurance policies with emphasis on fair treatment, the avoidance of price distortions, and the reliability of payment.

Virtually all insurance regulation in the United States is centralized (albeit on a state-by-state basis) in a *single* authority. Why? Because it is immaterial whether we are buying financial protection against loss on a home, a car, our health, employment, etc. A single regulator for the same service simply makes sense.

Multiple regulators also bring multiple (and sometimes incompatible) objectives. Compare, for example, the CFTC and the SEC. Each is charged by the Congress with advancing an important – but different – goal. The CFTC seeks to foster prudent hedging so that price risks – whether caused by rising or falling prices – can be offset through financial trading, and so the CFTC must be indifferent to price movements in *either direction* as long as they are not caused by deliberate market manipulation. On the other hand, the SEC seeks to encourage the public to contribute their funds to enterprises in the hope of having an even larger sum returned to them over time. That hope can normally be realized *only* if stock prices rise. So, unlike the CFTC, the SEC resists activity that is likely to depress stock prices. Both agencies are doing their job, and doing it correctly, but each would fail if it adopted the other's approach to price movements.

Another illustration involves disclosure of material information in CFTC- and SEC-regulated markets. Since the CFTC exists to support the availability of price insurance on an as-needed basis, it does not demand that a would-be hedger announce in advance its real or imagined predicament. In the SEC's world, on the other hand, the purchase or sale of a security based on that knowledge could be considered "insider trading" and thus unlawful. The distinction exists because futures markets have two different constituents – those who reduce their risks (hedgers) and those who willingly take those risks in the hope that their counterparty's fears – whatever they may be - will not materialize ("speculators"), while the SEC's constituents consist of a single class ("investors") who deserve to be equally informed for that reason.

Bottom Line: Unless your industry can get a single exclusive regulator for all of its futures activity – hedging its products or services, currency exposures, borrowing costs, etc. - the CFTC is and will remain the cheapest, most efficient solution.