

# LESSONS FROM ANOTHER CRISIS. US MARKETS REGULATION 1921-1925

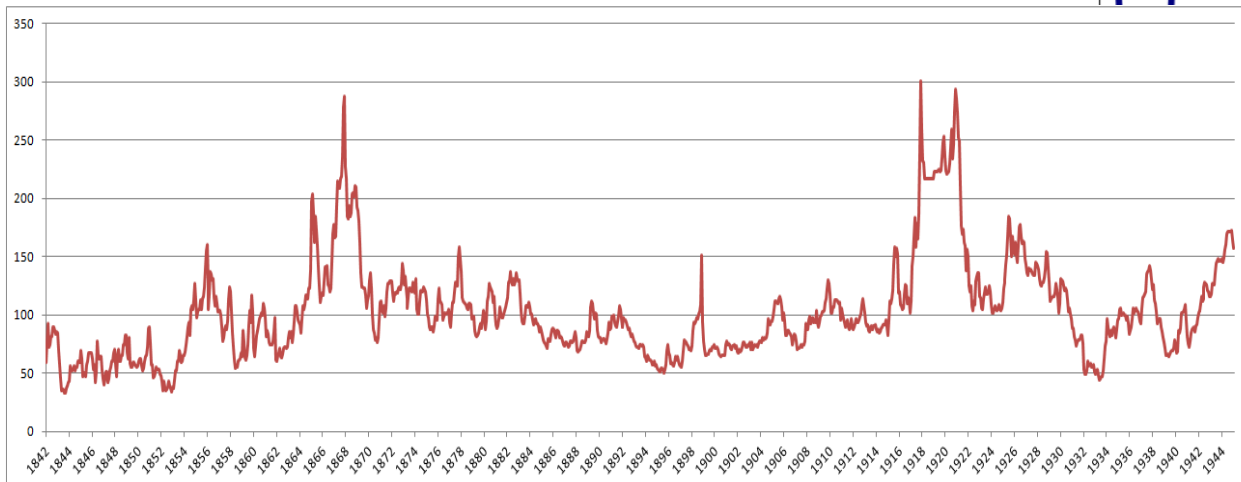
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- In 1920: Huge agricultural crisis
- The reaction was immediate: ‘knee jerk regulation’: 1921 First federal government regulation: 1922 Grain Futures Act and its administration
- Public record: **Failed attempts by government forces to heavily control or even shut down** the grain exchanges and therefore a victory of the self regulating free markets of Chicago

**Wheat price to farmers**





- **Case study: Informing on how governments and industry respond to financial crisis and what outcomes we can expect and why**
- 1920s saw the development of many of the **current** institutional characteristics of the exchange-traded derivatives markets
  - Reporting and monitoring of large positions in futures markets
  - Modern clearing house (in Chicago)
  - Business conduct committees

<b>Top 30 Derivatives Exchanges</b>					
<i>Ranked by number of contracts traded and/or cleared</i>					
Rank	Exchange	Jan-Dec 2013 Volume	Annual % Change	Dec 2013 Open Interest	Annual % Change
1	CME Group	3,161,476,638	9.2%	83,904,116	19.66%
2	IntercontinentalExchange * #	2,807,970,132	14.7%	135,377,377	12.93%
3	Eurex *	2,190,548,148	-4.4%	77,090,544	-2.52%
4	National Stock Exchange of India	2,135,637,457	6.2%	7,786,961	-40.60%
5	BM&FBovespa	1,603,600,651	-2.0%	56,666,689	-11.10%
6	CBOE Holdings *	1,187,642,669	4.7%	351,428	18.86%
7	Nasdaq OMX *	1,142,955,206	2.5%	7,196,312	6.61%
8	Moscow Exchange	1,134,477,258	6.8%	5,233,255	37.80%
9	Korea Exchange	820,664,621	-55.3%	2,683,821	5.11%
10	Multi Commodity Exchange of India	794,001,650	-17.3%	745,474	-68.47%
11	Dalian Commodity Exchange	700,500,777	10.7%	3,153,905	39.23%



# WHEAT FUTURES

- Buyer agrees to take delivery of a pre-specified amount within certain grades of wheat at any time during the delivery month at today's contract price. (e.g. May 1925 Wheat 10,000 bu. at \$2.00/bu.)
- The majority of contracts are closed out before delivery.
- Markets were (are?) rife with manipulation
- Trading takes place on an exchange, at the time a voluntary association of members. Nonmembers can trade through members
- Open outcry markets
  - Solving coordination problem - centralised auction style market with few frictions
  - 'Futures exchanges ...provide opportunities for...the establishment of efficient market prices'
- CBOT: Traded 22 bn bushels of grains by 1898 (many multiples of the total crop size)
- There can be no doubt that CBOT emerged from the interwar period with high market share and enduring institutions that were adopted by competitors and new markets. Is this *because* of the state or *in spite* of the state (or some combination)?



# THE GRAIN FUTURES ACT 1922

- Agricultural depression after the Great War
- Pressure to do 'something' but I argue that pragmatism was destined to prevail
- Grain Futures Act became law of 21 September 1922. Hastily passed update of the Futures Trading Act (HR 14657 Capper-Tincher Bill of 1921)
  - Prohibitive tax if not a designated contract market by the USDA
  - Reports required for 'special accounts' above a certain size
  - Established a new regulatory and information gathering agency reporting to the Secretary of Agriculture, the Grain Futures Administration
- Rules and regulations established in 1923
- No new regulation until 1936 (mild amendments adding cotton and protecting the small speculator), with no major changes until 1974



# ANTI FUTURES?

- ‘...909,000,000 [is the] loss the Chicago wheat gamblers have caused American wheat raisers in the last two months by gambling in futures... in the **biggest gambling hell in the world**... operated at the Chicago Board of Trade... Several weeks ago I began **work on measure to abolish** this injurious form of robbery and shall press this bill on the first day of the next Congress and **will undertake to put this den of thieves out of business**’.
  - Commercial and Financial Chronicle 16 Oct 1920 ‘Senator Capper declares against wheat futures’.
- On the passage of the Act - ‘The grain gamblers have made the exchange building in Chicago the world's greatest gambling house. Monte Carlo or the Casino at Habana are not to be compared with it’ - 61 Cong. Rec. 4761, 4763 (Aug. 9, 1921) (remarks of Sen. Capper).
- ‘Gambling’ tirade by Capper used by some to claim that what these ‘populist orators’ ‘lacked in economics they certainly made up for in elocution’ (Stassen 1982).

- Political and administrative theory
  - “It is not far from the truth to say that Congress in session is Congress on public exhibition, whilst Congress in its committee rooms is Congress at work.” - Woodrow Wilson 1885
- Cox and McCubbins ‘Agenda Power in the US House of Representatives 1877 to 1986’
- Theory predicts that policy is not made publicly but (especially true at the time) the powerful Congressional Committees in consultation with technocratic elite and industry



- Economic theory of regulation
  - Many interests vying for government intervention, but it is often the industry itself that can best lobby for protection
  - ‘...regulation is acquired by the industry and is designed and operated primarily for its benefit’ (Stigler, 1971 p. 1).
  - Both the regulations and the regulators may be ‘captured’ by industry interests
  
- Alternatives to self regulation as being in the public interest
  - Traders are rent seeking and/or can enter into manipulation as maximising their own utility (Pirrongo 1995)





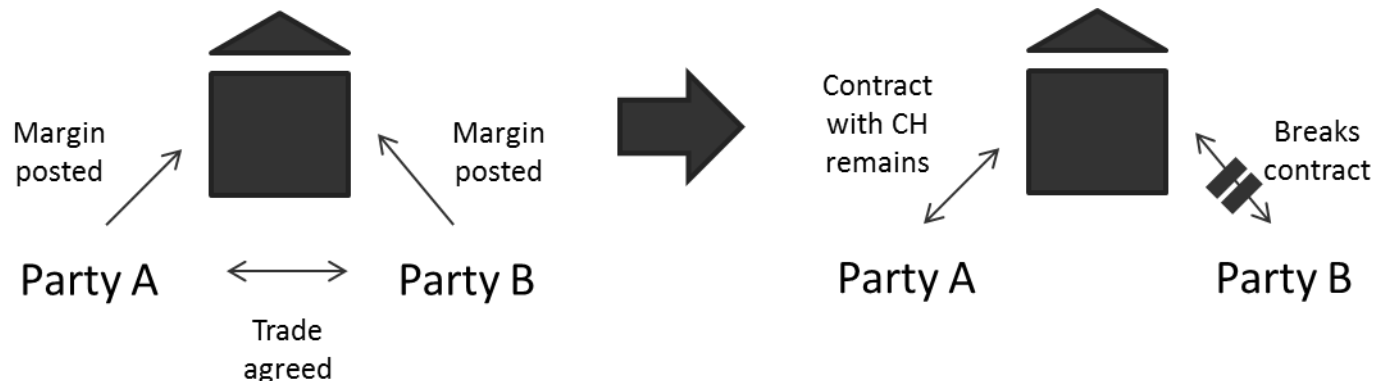
# CBOT IN PRIVATE

- '[Capper's 'gambling hell'] tirade ... in no respect had reference to legislation enacted by the adoption of his bill'
- '...no good end was to be achieved by a long dissertation in denial of his charge'
- 'The plain and simple facts are ... the bill is drafted substantially as we wished'
- '...we forced a compromise...'
- 'As they yielded substantially to us on the substance... I do not see how we could have acted differently'.
- 'a sentiment in Washington that some legislation should pass', so the Act 'removes the popular clamor'
- 'very likely prevent onslaught against us in the different State legislatures'
- 'it will be well to explain to our exchange friends... our passivity.'

- CBOT lobby had support in powerful places such as with Herbert Hoover
  - CBOT regularly met with President Hoover and the Sec. of Ag.
  - When it got particularly egregious, politicians got upset. 23 Dec 1929 III.16.15 When Secretary Legge met with lobbyist Barnes and his grain men, he was hauled before senate committee for it.
- CBOT asked to recommend GFA heads and officials 21 June 1923 III.660.1
  - Was CBOT's idea during lobbying
  - So on the ground enforcement captured even before it started
- CBOT allowed to make exchange-friendly changes to detailed rules and regulations. (2 June 1923 III.667.2)
- CBOT exec happy with Act: fought with members and directors, who wanted to have the Act overturned and new legislation put in its place (III.11.9 7 May 1924).

- GFA / Sec of Ag. Were able to cajole CBOT members into accepting **two of the most fundamentally important elements** of the modern futures markets.
  - Clearing house and BCC
  - Regulations written in collaboration with the CBOT
- Act of 1922 strengthened the CBOT **grain futures monopoly** (CBOT designated a contract market)
- Act legitimised but also fully legalised futures trading.
  - Federal regulation preferable to state regulation ‘shambles’ (III.16.7 29 April 1925)
  - CBOT officially recognized as ‘in the public interest’ and futures legally supported
  - CBOT had been spending a great deal of money providing its top legal talent to legitimacy challenges in the courts (members’ delinquent clients). (Eg III.91.2).
  - Protected from anti-futures bills at state level, as well as now supported in civil claims that sought to set aside loss claims on ‘gambling’ grounds
  - Elimination of bucket shops decreased anti-futures sentiment
- Prevented additional regulation
  - Farm groups felt that ‘something’ was being done, so eased protests.
  - Information gathered showed that speculation was not a major factor in macro cycle price moves.

- Executive made several unsuccessful attempts to establish modern CH
  - Board rejected clearing in 1920 – ‘would never work’
  - 1924-1925: Powerful members such as Armour Grain against
- 10 July 1925: Board President Carey wanted Secretary Jardine to ‘order’ the CBOT to start a modern clearing house for its own good (III.11.9).
- On 30 July 1925, President Carey begs Jardine to ‘support’ the CH to counter powerful anti-CH interests.
- On 15 Aug 1925, Jardine officially threatens CBOT with ‘legislation’ if CH not enacted (III.11.9)





# PARALLELS TO TODAY

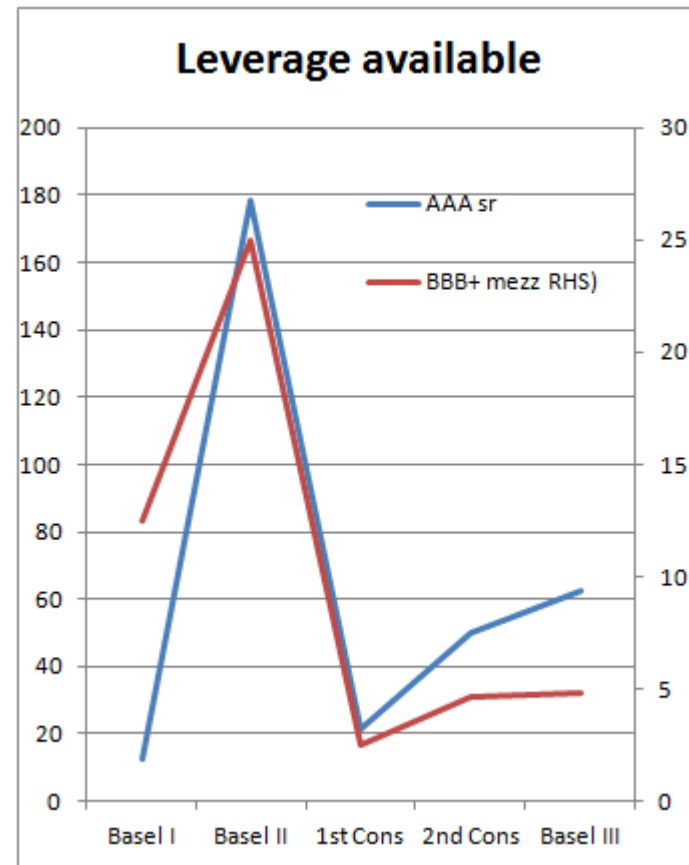
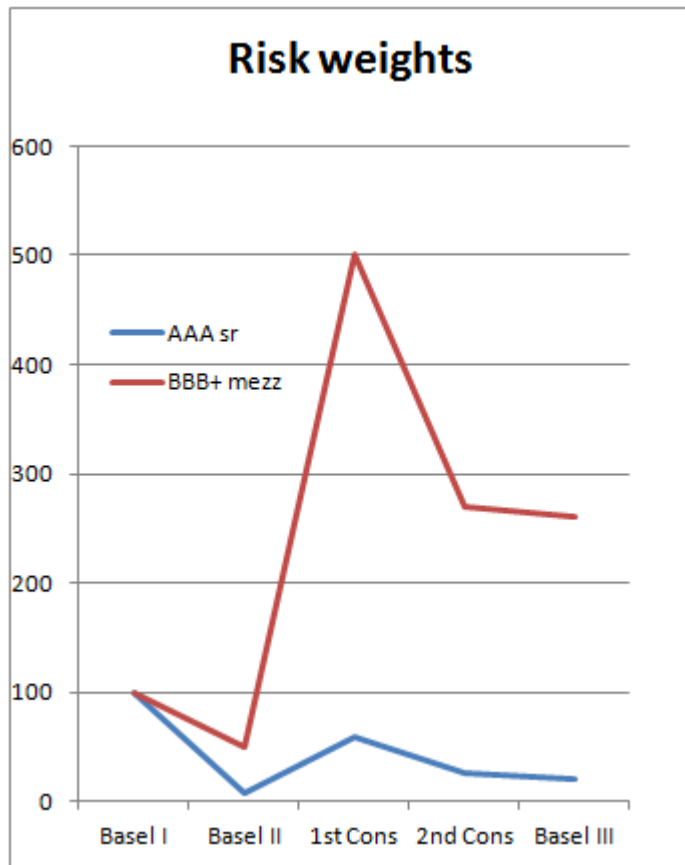
- Requires clearing houses for most OTC derivative transactions
- Resulted in increased (monopoly?) powers to the survivors such as JPMorgan and BAML
- Actual rules are being watered down through consultation with industry or other lobbying
- Re-legitimization of the financial markets as important for the real economy
- Regulation focused on where the accident happened (US subprime securitization vs wheat) , but on other potential problem areas (e.g. sovereign risk and money market funds).
- Focus on transparency as cure



# CURRENT TECHNOCRATIC DEBATES

- Exemptions for 'high quality' securitisations (prime mortgages), or for 'transparent' or 'standardised' transactions
- Discourse of the essential-ness of securitisation
- Public support for the risky and or for funding
- What to stress test? Subprime experience? European mortgage experience? Where is the next crisis going to come from?
- Roll back of higher capital requirements
- Transparency is always the answer (but transparency was not the problem – transparency of investors in securitisations was!)

- Pavlovian response and the pushback for securitisation capital requirements





## FURTHER DISCUSSION

- Can knowing how the regulatory and industry landscape can be altered post crises help us improve outcomes?
- How can we design stress tests that prevent the GFC but not the benefits (if any) of fractional reserve banking?
- What kind of capital adequacy regime would allow banks and shadow banks to survive a subprime-like meltdown in another asset class?