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# Cost-Benefit Analysis and the Commodity Futures Trading Commission (CFTC)

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## **Cost-Benefit Analysis and the Commodity Futures Trading Commission (CFTC)**

William P. Albrecht\*

My assignment today is to address the desirability and feasibility of using cost-benefit analysis (CBA) to evaluate financial regulation with a focus on some rules recently proposed by the Commodity Futures Trading Commission (CFTC). I will do this by examining a few of the many sets of rules proposed by the Commission in order to implement the Dodd-Frank Act. I will start with a brief look at what the CFTC said about costs and benefits done in four rulemakings and then examine in more detail the proposed rules dealing with Core Principles and Other Requirements for Swap Execution Facilities (SEFs), published in the Federal Register on January 7, 2011. I have chosen these particular rules because they are extremely consequential and controversial, and because January 7th is my birthday.

I would like to begin by emphasizing that this is not an attempt to evaluate, criticize or complain about any of the rules proposed by the CFTC. I could do that, but not today.

I would also like to emphasize how impressed I am by the amount of work undertaken and accomplished by the Commission since the Act was signed into law on July 21, 2010. It has issued approximately 60 sets of proposed rules. Many of them, including the one being most thoroughly discussed today, are extremely complex. As impressive as the amount of work done by the CFTC is the care, thought and consultation that went into these proposals. There have been hundreds of meetings with market participants and countless meetings within the Commission, and now the staff is working its way through the mountains of comments these proposals have generated. To the best of my knowledge, the entire process has been about as transparent as feasible.

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In the first 8 months of 1993, when I was acting chairman of the CFTC, we were able to publish all the proposals for rules required by the Futures Trading Practices Act of 1992. We were all very proud of this accomplishment, and with some justification. The staff put in long, long hours so that we could complete this task before I left the Commission at the end of August. But our undertaking was nothing like that given to the Commission by Dodd-Frank. Many people can certainly take issue with parts of the package, but it is hard to deny that this massive, groundbreaking, complex, comprehensive set of rules is quite an accomplishment, especially in such a short period of time. I can only assume that Chairman Gensler has found a way to keep to a minimum the tendency of all staff members to leave their marks on each document and to want their marks to be the last.

## CBA and the CFTC

The monumental body of work produced by the CFTC, in both the rules under discussion today, and in all the Dodd-Frank rules, does not contain any real CBA. Nor would one expect it to. Section 15(a) of the Commodity Exchange Act (CEA), which sets forth the duties of the agency, requires the CFTC to consider the costs and benefits of its proposed regulations, but it does not require quantification of them. [7 U.S.C. 19(a)] It also does not require the agency to determine whether the benefits exceed the costs nor whether the proposed rules are the most cost effective ways of achieving their goals.<sup>1</sup> All the Act requires is that the CFTC *consider* the costs and benefits of its actions and to evaluate the costs and benefits in five broad areas of market and public concern:

1. Protection of market participants and the public
2. Efficiency, competitiveness, financial integrity of financial markets
3. Price discovery
4. Sound risk management practices
5. Other public considerations

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<sup>1</sup> The CFTC is required to estimate the paperwork burden its regulations will impose on market participants. For the regulations in this one (of 57) the estimate is 308 hours for each of 35 respondents annually at an average cost of \$52 per hour. This amounts to \$16,016 annually for each firm for a total of \$560,569 per annum.

This rather limited requirement was added to the Commodity Exchange Act in 2000. To the best of my knowledge, it has not had a significant impact on a single CFTC rule or regulation. Nor has it had a significant impact on any of the proposed Dodd-Frank rules. Consider the following examples of some different types of rules in the 60 pending rulemakings under Dodd-Frank.

### ***Swap Dealers and Major Swap Participants***

This proposed regulation would set forth certain requirements for documenting the trading relationship between swap dealers, major swap participants and their counterparties. One section, for example, would require written policies to ensure that all parties have agreed in writing to all terms governing their swap trading relationship. Another proposes procedures to establish swap valuation procedures. (Federal Register/Vol. 26. No. 26/Feb. 8, 2011/pp. 6715-6727):

#### **Costs**

With respect to costs, the Commission has determined that the costs, which would be borne by swap dealers and major swap participants...are far outweighed by the benefits that would accrue to the financial system as a whole as a result of the implementation of the new rules...For example, many market participants already use standardized documentation.

#### **Benefits**

With respect to benefits, the Commission has determined that the proposed regulations that would require a swap dealer or major swap participant to document its swap trading relationship with each of its counterparties will promote standardization of documents and transactions, facilitate central trading and clearing, promote legal and financial certainty, decrease the number and scope of counterparty disputes...

### ***Commodity Pool Operators (CPOs) and Commodity Trading Advisers (CTAs)***

The proposed rules deal primarily with record keeping and information disclosure rules for CPOs and CTAs. One section would require a CPO or CTA to make and keep certain books and records generated by swap transactions for pool participants and for themselves. Other sections modify existing record keeping rules. (Federal Register/Vol. 76, No. 42/ Mar. 3, 2011/pp.11701-11705):

**Costs**

With respect to costs, the Commission has determined that the costs of this proposal would not be significant.

**Benefits**

With respect to benefits, the Commission has determined that the benefits of this proposal would be significant. This is because it would enhance the customer protections currently provided by increasing the transparency of swap activities by CPOs and CTAs to their pool participants and clients.

***Conflicts of Interest in Derivative Clearing Organizations (DCO's), Designated Contract Markets (DCMs), and SEFs***

These rules would limit potential conflicts of interest. (Federal Register/Vol. 75, No. 235/Nov.23, 2010, pp. 71391-71397):

**Costs**

Conflicts of interest facing a DCO may have detrimental effects on the public because they may impede the mandatory clearing of swaps...Also, such conflicts may also evidence less sound management practices...Also, such conflicts may have detrimental effects on market participants as well as on efficiency and competition.

**Benefits**

The proposals mitigate the conflicts of interest and, therefore, the detrimental effects resulting from such conflicts. The Commission believes that the benefits of such mitigation exceed the cost

***Position Limits***

These rules would establish position limits for certain physical commodities and for certain futures and options contracts. (Federal Register/ Vol.76, No.17/ Jan.26, 2011/pp. 4753-4777):

**Costs**

The proposed position limits and their concomitant limitation on trading activity could impose certain general but significant costs. Overly restrictive limits could cause unintended consequences by...decreasing liquidity in the markets for the referenced contracts, impairing price discovery...and encouraging the migration of speculative activity to markets outside of the Commission's jurisdiction.

## Benefits

The proposed regulations may...promote the financial integrity of the markets and protect the public by reducing systemic risk insofar as [they] would reduce the likelihood such leveraged entities to generate systemic risk by either limiting their ability to amass a very large speculative position or by making such entities more visible to the Commission.

Clearly, there is no authentic CBA in these discussions. The Commission simply asserts that benefits exceed costs.

## Proposed Rules for Swap Exchange Facilities

Now let's take a look at the proposed SEF rules, which are outlined in Appendix A. (Federal Register/Vol. 76, No. 5/Jan. 7, 2011/pp. 1214-1259)e) The Act sets forth 15 core principles for the operation of SEFs. They are listed in Table 1. There is nothing very controversial about these principles. Virtually all regulators and market participants would swear allegiance to them. The controversial issue is the extent to which regulators decide how to implement the principles. For the purposes of the current discussion the question is whether a requirement for CBA would be useful in this area

**Table 1. Core Principles**

1. Compliance with core principles
2. Compliance with rules
3. Swaps not readily susceptible to manipulation
4. Monitoring of trading and trade processing
5. Ability to obtain information
6. Position limits or accountability
7. Financial integrity of transactions
8. Emergency authority
9. Timely publication of trading information
10. Recordkeeping and reporting
11. Antitrust considerations
12. Conflicts of interest
13. Financial resources
14. System safeguards
15. Designation of Chief Compliance Officer

## **Cost-Benefit Analysis**

This is what the CFTC has to say about the cost of its proposed SEF rules (Federal Register/Vol. 76, No. 5/Jan. 7, 2011/, p. 1237):

As highlighted by recent events in the global credit markets, transacting of swaps in unregulated OTC markets does not contribute to the goal of stability in the broader financial markets. The public would continue to be at risk to such financial instability if certain derivatives were allowed to trade over the counter rather than on regulated exchanges. SEFs that determine to register with the Commission in order to provide for the transacting of swaps will be subject to core principles for transacting of swaps. If swaps were allowed to continue to be transacted bilaterally, rather than on the regulated market of an SEF, price discovery and transparency would continue to be inhibited. These procedures are mandatory pursuant to the Dodd-Frank Act and any additional costs associated with these procedures are required by the implementation of the Dodd-Frank Act.

In other words, it does not matter what the costs are. These rules are mandated by the Act and that is that. The Commission is, of course correct. It has to do what the law tells it to do.

## **Benefits**

Now let us see what the CFTC says about the benefits (Federal Register/Vol. 76, No. 5/Jan. 7, 2011/, p. 1237):

The Commission believes that the benefits of the rulemaking are significant. The proposed regulations provide for the transacting of swaps on SEFs. SEFs will compete with direct clearing members (DCMs) that make certain swaps available for trading, while certain swaps will continue to transact bilaterally. This competition will benefit the marketplace. Providing market participants with the ability to trade certain swaps openly and competitively on an SEF complying with all the SEF core principles as well as on DCMs complying with DCM core principles will provide market participants with additional choices and will enhance price transparency resulting in protection of market participants and the public. The proposed regulations will necessitate that SEFs determine to make certain swaps available for trading will have to coordinate with derivative clearing organizations (DCOs) in order to effect clearing and thus be subject to the DCO's risk management and margining procedures.

The conclusions reflect the thinking underlying the Dodd-Frank Act. The Commission cannot challenge these premises. Its job is to implement the law. Certainly it is true that, if the proposed rules substantially reduce the probability of a repeat of the financial mayhem of 2007 and 2008, there are positive net benefits. This is because the benefits are so large that it does not



matter what the costs are. Although there are many of us with doubts as to whether the benefits will be as great as predicted, it is difficult to see how the CFTC can do anything but accept what the authors of Dodd-Frank believe.

We all recognize, however, that efficiency requires more than positive net benefits. CBA would require that the costs of alternative means of achieving a particular set of benefits be determined. The CFTC is well aware of this issue and argues that the particular set of regulations proposed it has proposed is the cost effective way of achieving the goals of the Dodd-Frank Act.

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In consideration of the novel nature of SEFs and also based on experience in overseeing DCMs, the Commission carefully assessed which core principles would benefit from regulations, providing legal certainty and clarity to the marketplace, and which core principles would benefit from guidance or acceptable practices where flexibility is more appropriate. Based on that evaluation, the Commission is proposing a combination of regulations, guidance and acceptable practices...

One certainly cannot argue with this statement, but one certainly might not agree that the proposed rules strike the appropriate balance between protection from undue risks of instability and burdensome regulations on market participants. In fact, one member of the Commission does not. Commissioner Sommers has written a dissent dealing with the way the proposed rules define an SEF. In this dissent, she points out that Dodd-Frank defines an SEF as a trading system or platform in which multiple participants have the ability to execute or trade swaps by accepting bids and offers made by multiple participants in the facility or system, through any means of interstate commerce, including any trading facility.

There are some new terms here. The Commodity Exchange Act defines trading facility but not trading system and trading platform. The question raised by Commissioner Sommers objects to the proposed definition of these terms. In her dissent, she says (Federal Register/Vol. 76, No. 5/Jan. 7, 2011/, p. 1259):

I believe Congress intended a broad model for clearing swaps, both cleared and uncleared...The goals identified by Dodd-Frank for registering swaps are to promote the trading of swaps on SEFs and to promote pre-trade price transparency in the swaps market ...In my view, the best way to achieve the twin

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<sup>2</sup> It is also possible that the goals of the Act are not attainable and that the Act itself makes them even less attainable.

goals is to adopt a model that provides the maximum of flexibility as to the method of trading. This proposal does not do that...It restricts competition by shutting out applicants...

The dissenting member of the Commission believes that competition will be limited by the provision that requires an SEF to be able to post both firm and indicative quotes on a centralized electronic screen accessible to all market participants who have access to this SEF. Is she correct in her reasoning? It is quite possible that a stronger CBA requirement in the Commodity Exchange Act might force the Commission to address this particular question and the balance issue in general more fully.

### **Is CBA Feasible or Desirable?**

I am confident that a vast majority of CFTC staff and of the Commission itself would argue that any detailed CBA of the proposed Dodd-Frank rules is impossible. They would also argue that it would be pointless to evaluate rules that are required by the law. And they would argue that a serious effort at CBA would require vastly more staff... to undertake mission impossible.

There is a great deal of truth in these concerns. Certainly to undertake serious CBA of all the Dodd-Frank rules could be as monumental a task as writing all 60 sets of rules. In fact, meaningful CBA of just the SEF rules would be a staggering task. One reason is that the CFTC has never had to develop CBA expertise. If required to do so, it would over time, develop some expertise and the task would be less daunting. In the case of SEFs, however, the rulemaking is a brand new ball game. The CFTC is making rules for entities that do not exist.

Is it even possible for an agency to devise a full-fledged detailed set of regulations under these circumstances? Developing expertise in a known unknown is quite difficult. And it is even more difficult when it comes to the unknown unknowns. What new forms of financial engineering and financial institutions will emerge in response to the SEF and other Dodd-Frank rules? One wishes that the authors of the Act had realized that rules typically evolve as an institution evolves. If they had, the regulators responsible for implementing it might have been encouraged to permit more flexibility.

Even within the rigid confines of Dodd-Frank, however, the CFTC could have permitted more flexibility than it has proposed. CBA could be helpful in determining how much flexibility to allow. I would argue, however, that while CBA can be useful in CFTC rulemakings, it can, at best, provide guidance rather than answers. The complexity of the many proposals, such as those

for SEFs and other parts of Dodd-Frank makes CBA more of art than a science. But the art can be useful.

A good starting point might be to require more detailed analysis of the costs of alternative means of accomplishing a particular goal. This would help the agency develop CBA expertise and should, over time, lead to a deeper understanding of the costs of regulation.

## Unintended Consequences

Just as regulations usually have unintended consequences, so can CBA. One is that an excessive focus on quantitative cost estimates can lead to a serious underestimation of costs. When thinking of cost, most people tend to think of explicit, measurable costs such as direct compliance costs incurred by regulated firms. These include the cost of establishing, monitoring and enforcing internal procedures that ensure compliance with the externally imposed rules.

Unfortunately, many of the real costs of regulations are not mentioned in most discussions of costs. Regulations typically retard innovation, reduce competition, and provide incentives for rent-seeking. All too often they lead to a waste of resources. Consider the following example. When I was at the CFTC, a man with a net worth of about \$500 million had lost \$25 million speculating in currency options. He refused to pay his brokers that amount on the grounds that they had illegally sold him the options. He argued that he was not a qualified buyer and that they should not have let him buy the options. The case hinged upon whether, in the relevant statute, the phrase “in options” meant “in options” or whether it meant “in or involving options”. The amount of high powered legal talent hired by both sides was impressive, as were their arguments. The CFTC got involved in the case as a friend of the court, and we also devoted a significant amount of our own high powered (although lower paid) staff to the effort to help the court understand what “in” meant. Ultimately the court case was costly and appeared to involve a total expenditure equal to a significant fraction of the total resources at stake.

Regulation always encourages rent-seeking by market participants. They often are willing to spend up to the amount to be gained or lost in order to change or forestall regulatory changes. Such costs can be significant and will not (and cannot) be included in a regulator’s CBA.

Another danger in CBA is that the rules can be changed to suit political purposes. My favorite example involves the CBA used by the Corps of Engineers in evaluating the merits of proposals for building dams. Quite a few years ago, when CBA led to the rejection of several dams sought by some members of Congress, the rules were changed. The Corps was told to use a lower discount rate to determine the present value of the future benefits of the dams. Magically,

CBA now told the Corps to build the dams and no one could argue that the costs exceeded the benefits.

What would happen if the CFTC did develop some expertise at CBA and used this expertise to justify rejecting a regulation that some powerful members of Congress wanted? These members would likely tell the CFTC to use a different formula for calculating costs and benefits or to use different assumptions in making these calculations.

## **Conclusions**

Cost-benefit analysis of financial regulation is difficult and often overlooks many costs and benefits. Political pressure may distort the results of CBA. This may lead to the danger of the political use of CBA to justify inefficient regulations. But there are many, many inefficient regulations now. Surely more emphasis on CBA would, on balance, lead to a more efficient regulatory regime. It would be useful for regulators such as the CFTC to be required to undertake more rigorous CBA than they currently do. This would certainly not solve the problem of inefficient regulations, but it should help.

## Appendix A

### ***CFTC Proposed Rulemaking Dodd-Frank Act***

#### Subpart A-General Provisions

- Requirements for registration
- Procedures for listing products and implementing rules
- Information relating to SEF compliance
- Prohibited use of data collected for regulatory purposes
- Boards of trade operating both a DCM and a SEF
- Permitted execution methods
- Assessments regarding transactional tiers or platforms and swaps made available for trading
- Identification of non-cleared swaps or swaps not made available to trade

#### Subpart B-Compliance with core principles

#### Subpart C-Compliance with rules

- Operation of SEF and compliance with rules
- Access requirements
- Rule enforcement program
- Regulatory services provided by a third party
- Audit trail requirements
- Disciplinary procedures and sanctions
- Swaps subject to mandatory clearing

#### Subpart D-Swaps not readily subject to manipulation

#### Subpart E- Monitoring of trading and trade processing

- Additional requirements for physical-delivery swaps
- Additional requirements for physical delivery swaps
- Ability to obtain information
- Risk controls for trading
- Trade reconstruction
- Additional rules required

Subpart F-Ability to obtain information

- Establish and enforce rules
- Collection of information
- Provide information to the commission
- Information-sharing agreements

Subpart G-Position limits or accountability

Subpart H-Financial integrity of transactions

- Mandatory clearing
- General financial integrity
- Monitoring for financial soundness

Subpart I-Emergency authority

- Additional sources for compliance

Subpart J-Timely publication of trading information

- General Requirement
- Capacity of SEF

Subpart K-Recordkeeping and reporting

- Recordkeeping required
- Reporting to the commission required
- Inspection and examination by the SEC

Subpart L-Antitrust considerations

- Additional sources for compliance

Subpart M-Conflicts of interest

Subpart N-Financial resources

- General requirements
- Types of financial resources
- Computation of financial resource requirement
- Valuation of financial resources
- Liquidity of financial resources
- Reporting requirements

Subpart O-System safeguards

- Requirements

Subpart P-Designation of Chief Compliance Officer

Appendix A-Form SEF

Appendix B-Guidance on, and Acceptable Practices in, Compliance with Core Principles