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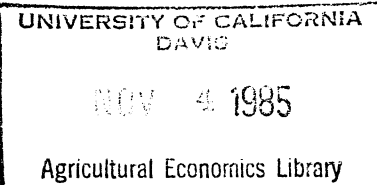
[aesearch@umn.edu](mailto:aesearch@umn.edu)

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MARKET INTEGRITY ISSUES AND  
THE AGRICULTURAL MARKETS



I. Introduction

- A) Market integrity issues apply to all futures markets but are particularly critical in Agricultural markets because of lower volume and the potential for abuses that thin markets provide.
- B) This is a particularly sensitive subject - the audit trails systems proposal is probably the most sensitive and controversial regulatory issue facing the industry today - it is also timely. CFTC will go through the reauthorization process during the next 12 months.
- C) The futures industry, like agriculture, is going through profound structural changes - declining prices, declining volume in the traditional markets - excess capacity in the traditional areas, bankruptcy of firms, combinations, etc. - declining value of assets.

II. The Proposed Audit Trails Systems  
(1 minute time stamping)

- A) CFTC has been wrestling with this issue since its inception 10 years ago.
  - With present techniques it's impossible to completely reconstruct trading in order to determine if trading violations have occurred.
  - The frequent acquisition of widespread trading abuses can neither be proven or disproven.
  - CFTC's recent investigation of "Insider Trading" and investigation of the sharp fluctuations in the soybean market in August 1983 are both examples where a system of sequential trade reconstruction that was verifiable mechanically or electronically would have allowed CFTC to either pursue the allegations or lay them to rest - wash trading, prearranged trading, and cross trading are all areas where trade reconstruction potentials are important.

James A. Culver  
Merrill Lynch Futures

AAEA paper

1985

Future trading

B) CFTC's proposal calls for "sequential reconstruction of trading and verifiably mechanical or electronic recording of the time of trade execution to the nearest minute.

- Currently regulations provide for 30-minute brackets.
- The commission suggests that with current technology, that electronic data entry terminals for every trader would solve the problem.
- The exchanges have argued that no such "off the shelf" technology exists and that while it may be possible to produce, it will take time and money, lots of it, to produce.
- It's unclear to me who is correct -- I'm not a techie.

C) Recommendations

- If CFTC is correct, they are going to have to get involved and prove it.
- If on the other hand, the exchanges are correct, the status quo should not be allowed to stand.
- There are things we can do to improve audit trails without the use of new technology and we need additional and better information on order execution.
- Effective audit trails depend on 3 things.
  - o Accuracy of raw data.
  - o Speed and reliability of evaluative systems.
  - o Certainty of disciplinary action against those who consistently fail to provide accurate data or who are found to be engaging in abusive trading practices.
- The simplest method of determining the time of execution would be to require a trader to note it on the ticket along with all the other data he is required to record.
- This would not be fool proof but would be a major improvement over the present systems.
- Speed and reliability of analytical systems and certainty of disciplinary action do not require - new technology.
- They do require vigilance by both CFTC and the exchanges and both could be improved.

### III. Manipulation

- Agreed to discuss
- Problems with lawyers
- Officer of regulated firm - public forum including regulators
- Anything I could say would be wrong

However --

#### A) Does it exist and what is it - great confusion

- Legal definitions - economic definitions - group of economist who don't believe it exists.
- Others say maybe it does but it doesn't matter.
- CFTC has problems with it - in CEA days had a manipulation or closely related conviction every 2 or 3 years. Since inception of CFTC haven't been any.

#### B) Given this record is manipulation worth worrying about?

#### C) Maybe what we should spend our time on instead of worrying about manipulation is looking for a new theory or methodology of regulation of futures that doesn't depend so much on manipulation.

- Could we design a system that focused more on the delivery firms and customer.
- More emphasis on protection issues and less on the specific structures of the instruments traded.
- Benefits of such a system of regulation would include more innovative types of instruments including not just new futures but maybe new types of trading even.