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Proposed Transaction Fee on Futures Contracts

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Summary

The Bush Administration has revived a proposal, made by every President since Ronald Reagan but never enacted by Congress, to impose a user fee on trading in the futures markets in order to fund the Commodity Futures Trading Commission (CFTC). Fees paid by other financial market participants already provide funding for the Securities and Exchange Commission (SEC) and the federal banking regulators. To fund the CFTC at the level requested for FY2007 ($127 million) would require a fee of about seven cents on each futures contract and option traded on the exchanges that the CFTC regulates. The futures industry argues that such a fee would be anticompetitive and could divert trading to foreign markets or to the unregulated over-the-counter market. However, it is not clear that a fee of this relatively modest size would have a significant impact on trading decisions in a market where the value of a single contract may rise or fall by hundreds or thousands of dollars in a day. This report summarizes the arguments for and against the proposal and will be updated as legislative developments warrant.

As part of its budget for FY2007, the Bush Administration has proposed that the Commodity Futures Trading Commission (CFTC) be funded by a transaction fee on futures contracts, rather than by appropriated funds. The CFTC is the federal regulator of the futures markets, where financial contracts based on the price of commodities, currencies, interest rates, and other financial indicators are traded. Its budget authority for fiscal 2006 is $97 million. For FY2007, the Administration has requested an increase to $127 million, in recognition of growth and change in the markets that the agency regulates.

The same futures transaction fee proposal was included in the Administration's FY2003 budget but was not enacted by Congress. Indeed, every Administration since Ronald Reagan's has called unsuccessfully for such a fee.

The Size of the Fee

The FY2007 budget does not specify any particular fee amount or rate, but simply notes that the proposed fee would "cover the cost of the CFTC's regulatory activities."[1] Assuming that this means the entire CFTC budget, and that a uniform fee is to be imposed on each futures and options contract traded on U.S. futures exchanges, a fee of 5.1¢ per contract would be required to cover the CFTC's FY2006 budget, or a fee of 6.7¢ to cover the proposed increase to $127 million. (This calculation is based on trading volumes reported by the CFTC for fiscal 2005: 1.554 billion futures contracts and 353 million options.[2])

How significant is a fee of this magnitude in the context of futures trading? Futures contract size varies according to the underlying commodity, but the amounts involved in a single contract are substantial. For example, a corn futures contract on the Chicago Board of Trade represents 5,000 bushels of corn. Prices are quoted in increments of 1/4 cent per bushel (called the *tick size*), meaning that the smallest possible price fluctuation is $12.50 per contract. On the Chicago Mercantile Exchange, a futures contract based on the Standard and Poor's (S&P's) 500 stock index represents $250 times the current S&P index value. The tick size is 0.1 index point, so that the minimum price fluctuation per contract is $12.50. Of course, over the life of a contract, prices normally fluctuate much more than a single tick: when the S&P 500 — currently about 1,300 — rises or falls by 0.5 %, each futures contract changes in value by $1,625 (assuming 6.5 index points times $250).

The fee would also be quite small in relation to other trading costs. On the Chicago Board of Trade, exchange and clearing fees average about 50¢ per contract.[3] The brokerage fees paid by traders who are not exchange members are subject to negotiation, but generally range from about $5 per contract for a discount broker to several times that amount for full-service brokerage.

Transaction Fees in the Stock Market

A likely model for the proposed CFTC fee is the set of fees that fund the Securities and Exchange Commission (SEC), which regulates stock and bond markets. There are three principal fees: (1) all sales of stock on a U.S. exchange or on Nasdaq are subject to a fee, in the form of a percentage of the sale price; (2) corporations pay a percentage of the value of new stock or bonds registered with the SEC prior to sale to the public; and (3) certain merger and tender offer transactions are subject to fees. The SEC is required to adjust the fee rates periodically to ensure that the amount collected is approximately equal to the agency's budget.

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[1] *The Budget for Fiscal Year 2007, Appendix,* p. 1119.

[2] Stock options are not included in this total: they are traded on securities exchanges regulated by the SEC and are subject to transaction fees that are earmarked to support the SEC's budget.

[3] "CBOT 2005 Volume Surpasses 674 Million Contracts and Marks Fourth Consecutive Year of Growth," Chicago Board of Trade Press Release, Jan. 3, 2006.

When the fees are collected, they go to a special offsetting account available to appropriators, not to the Treasury's general fund. As a result of the fee collections, no direct appropriations are used to fund the SEC.

The rates were most recently adjusted in November 2005. For stock sales, the fee is $30.70 per million dollars, or 0.003%. For registration of new securities and mergers, the rate is $107 per million, or 0.01% of transaction value.

Arguments For and Against the Fee

The basic argument for a transaction fee is that those who benefit most directly from federal regulation — users of the futures market — should bear the cost of that regulation, not the general taxpayer. The benefits of financial regulation, in terms of investor confidence and deterrence of fraud and price manipulation, are well-recognized. The Administration's budget notes that the "CFTC is the only federal financial regulator that does not derive its funding from the specialized entities it regulates."[4]

The futures industry opposes the fee on the grounds that it will make U.S. futures exchanges less competitive vis-a-vis foreign exchanges and the off-exchange, or over-the-counter market. According to John Damgard, president of the Futures Industry Association, "[t]he proposed tax on futures transactions would raise the costs of doing business on regulated futures exchanges and could discourage institutions and individuals from using futures contracts to manage their risks. Institutional players today have many choices. If exchange-traded products become less cost-efficient, they can choose to do business in the over-the-counter derivatives markets or move to more cost-efficient markets."[5]

Opponents of the fee also note that the futures exchanges themselves have regulatory functions, which are paid for by the trader membership, and that there are additional fees to fund the National Futures Association (NFA), a self-regulatory organization.[6]

Likely Impact of the Fee

It is true, as opponents of the fee argue, that the U.S. futures industry operates in a highly competitive environment. Foreign futures markets have grown rapidly in recent years, and in 2005 accounted for the majority of futures contracts traded.[7] This does not imply, however, that foreign growth has come at the expense of U.S. markets: in 2005, U.S. futures volume grew by 25.4%, while non-U.S. volume rose by 6.5%. Similarly, many contracts traded in the unregulated over-the-counter market compete directly with

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[4] Ibid.

[5] "FIA Strongly Opposes Proposed Tax on Futures Transactions," Futures Industry Association press release, Feb. 7, 2006.

[6] The NFA is analogous to the National Association of Securities Dealers (NASD) in securities markets. Futures traders must register with the NFA, just as all stockbrokers must join the NASD. Securities exchanges also maintain enforcement and market surveillance operations.

[7] The Futures Industry Association reports that global futures volume in calendar 2005 was 3.961 billion contracts, with U.S. exchanges accounting for 1.653 billion, or 42%.

exchange-traded products, but there is no indication as yet that either market has reached a saturation point. Rather than poaching from each other, it appears that both markets are attracting new customers.

The question is whether the competitive balance among these markets is so delicate that even a small increase in transaction costs could trigger a flight from U.S. futures exchanges. It is hard to imagine that any exchange customer, contemplating an investment that stands to gain or lose hundreds or thousands of dollars in a single day, will be deterred by an additional cost of six or seven cents. For exchange members, whose trading costs are much lower (primarily because they do not pay brokerage fees), the proposed fee would have a proportionately greater impact, but it is not clear that there would be any significant effect on trading decisions.

The securities market fees that fund the SEC cannot be directly compared with the proposed futures fee: SEC fees are percentages of trade value, and they are spread over many more investors, firms, and market professionals than would be the case in the futures industry. However, it may be worth noting that the SEC's budget has more than doubled since the Enron scandals and the Sarbanes-Oxley Act of 2002,[8] and that fee rates were raised at the same pace, without any marked impact on trading volumes or liquidity.

The Administration's budget calls for the fee to "be set at a level to avoid inhibiting the market's competitiveness."[9] A standard, per-contract fee at the level needed to fund the CFTC at its present size (or at the size proposed by the Administration's FY2007 budget) appears likely to meet that test.

[8] From $423 million in FY2002 to a requested $905 million for FY2007.

[9] *The Budget for Fiscal Year 2007, Appendix*, p. 1119.