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To cite this version:

HAL Id: hal-00561904
https://hal.archives-ouvertes.fr/hal-00561904
Submitted on 8 Feb 2011

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Disagreement-Based Trading and Speculation: Implications for Financial Regulation and Economic Theory

Yuri Biondi, CNRS, France
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Abstract

Lynn Stout’s paper develops an insightful legal-economic analysis of speculative trading. From one hand, the paper discusses the legal-economic framework of speculation and its recent transformation, making reference to the case of derivatives markets crash (and related financial crisis) of 2007. From another hand, the paper foreshadows a thought-provoking economic model of trade (and speculation) based on disagreement, advocating further developments that take into account market manipulation and conflict of interest, whilst relaxing alleged assumptions (and beliefs) on universal fundamental value and perfect forecasting.

KEYWORDS: economic theory, financial regulation, speculation, hedging, heterogeneous beliefs

JEL Classification Codes: D53, D82, D84, G01, G28, K20, B10, C70, D14
TABLE OF CONTENTS

1. IMPLICATIONS FOR FINANCIAL REGULATION
2. IMPLICATIONS FOR ECONOMIC THEORY
JUDICIAL SOURCES
REFERENCE

Biondi: Disagreement-Based Trading and Speculation

Published by Berkeley Electronic Press, 2011
Lynn Stout’s paper develops an insightful legal-economic analysis of speculative trading. Its implications are twofold: for financial regulation and economic theory.

1. Implications for financial regulation

From one hand, the paper discusses the legal-economic framework of speculation and its transformation between ancient and modern times, taking the case of the financial crisis and the derivatives market crash of 2007. The paper fundamentally questions the qualitative and quantitative importance of derivatives markets that nowadays dominate the creation and circulation of liquidity in the financial system. Leading financial intermediaries are now specialised in issuing those contracts and making those markets that the author criticises as giant casinos. And, as Ace Rothstein said: “In the casino, the cardinal rule is to keep them playing and to keep them coming back. The longer they play, the more they lose, and in the end, we get it all.”

First of all, the traditional common law approach suggests that the economic problem of speculation concerns the wrong incentives sent to economic actors involved in real investments. Encouraging such gambling would reduce society’s capacity to benefit from their efforts at work, because gambling is at best a zero-sum occupation in which one gambler’s gains exactly mirrored another’s losses. As a result, speculative derivatives bets would “promote no legitimate trade” (Melchert v. American Union Telegraph Co., 11 F. 193, 195 (D. Iowa 1882)) and “discourage the disposition to engage in steady business or labor” (Justh v. Holliday, 13 D.C. (2 Mackey) 346, 349 (1883)).

Furthermore, speculative trading introduces a huge conflict of interest between investors and the financial intermediary, since the latter can be at the same time the issuer and one of the gamblers of the derivative betting game. For instance, concerning a recent affair occurred when the U.S. housing market was beginning to falter, the SEC alleged on April 16, 2010 that Goldman Sachs structured and marketed a synthetic collateralized debt obligation (CDO) that hinged on the performance of subprime residential mortgage-backed securities (RMBS). Accordingly, Goldman Sachs failed to disclose to investors vital information about the CDO, in particular the role that a major hedge fund played in the portfolio selection process and the fact that the hedge fund had taken a short position.

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2 I am in debt to Lynn Stout for these references.
position against the CDO. According to the Wall Street Journal, Goldman Sachs “settled the case on July 15, agreeing to pay a $550 million and acknowledging a mistake in its handling of the deal.”

Lynn Stout criticises the modern drift away from the common sense, common law approach to derivatives products and markets. Both modern theories and regulations had been increasingly favouring derivatives issuance and trade, surely believing in their positive economic consequences. Amid the aftermath of the financial crisis of 2007, however, German Authorities decided on May 19, 2010 to ban naked short selling, marking a regulatory step against speculation aimed at increasing investors’ protection and improving the functioning of securities markets. These latter purposes may be achieved by forbidding cash settlements, obliging then involved traders to eventually deliver the underlying security at term. In contrast, the large majority of the transactions are at the present performed by traders who do not have any connection with the underlying security and its socio-economic context.

2. Implications for economic theory

From another hand, the author foreshadows a thought-provoking economic model of trade (and speculation) based on disagreement. This model suggests (contrary to Adam Smith) that not all mutually voluntary exchanges are also mutually beneficial, and further carries the unpalatable implications that consenting adults do not necessarily make choices that lead to socially optimal outcomes. In this context, regulatory design does matter and should be economically efficient, and effective for public policy.

Under conditions of asymmetric and limited knowledge, speculative trading can generate pricing distortion – related to market manipulation and moral hazard among others –, and diversion of financing (liquidity) from investing to speculating. From the theoretical viewpoint, the disagreement-based model of speculative trade provides then an understanding of the working of securities market that relaxes usual assumptions on universal fundamental value and perfect

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5 In naked short-selling, a trader sells a security - betting that it will fall - without owning it or ensuring that it can be acquired, as would be necessary in a conventional short sale.
forecasting. This is in line with the response by Henri Poincaré to Léon Walras concerning the early equilibrium model of the market developed by the latter:

… at the beginning of every mathematical investigation, there are some hypotheses and, to make that investigation fruitful, you must be aware of those hypotheses (...). Forgetting this condition means going beyond [what I called] the fair limits (...). For example, concerning mechanics, we do often disregard friction and consider bodies as perfectly polished. You, you look at human beings as unboundedly egoistic and unlimitedly farsighted. Whilst the first hypothesis can surely be admitted in a first approximation, the second should deserve further consideration.

Accordingly, the merely financial performance generated - for some time - by such gambling activity related to speculative trading should be checked out *ex post* against unexpected financial losses for many (contrary to huge financial gains for few, especially derivatives issuers and market-makers), and overall economic misallocation of resources.

Modern approaches by economic theory and regulation often assume that arbitrageurs can univocally identify mispriced securities and correct market prices according to the common knowledge of some universal fundamental value. Whenever arbitrageurs recognize positive (negative) misalignments, they start buying (selling) on the market, making the market price reversing to that overarching fundamental value. This view implies that informed traders can know (and agree on) *the* fundamental value of the underlying security. Lynn Stout’s


idea of trading on disagreement intriguingly claims against this assumption (and act of faith) on the actual working of securities markets over time.

Furthermore, modern approaches also assume that market intervention by arbitrageurs reallocates economic resources in the fashion that helps offset the effects of change of fundamental values. Whenever market prices increase (decrease), investors and entrepreneurs revise their investment choices. Real economic activities may then receive more (less) resources according to the expected fundamental values of those activities. Again, this view assumes (and requires) that aggregate forecasting by the market is perfectly right at every period of time, whenever choices are made. Otherwise, if the market price is right only on average – implying that current price consensus moves up and down around the so-called fundamental value in some aleatory way –, it will send biased signals to real investments, leading to bullish and bearish mistakes in the meanwhile. And this misallocation of resources may be even worst if bubble formation (so-called market exuberance, whatever rational or irrational) is taken into account.

Finally, the author invites us to question a financial system based upon self-fulfilling prophecies and crystal balls. Following a Greek philosopher, we can argue that, first of all, the fundamental value does not exist; later, even if it existed, man could not know it; finally, even if he knew it, he never could represent and explain it to others. Eventually, who can perfectly know the future? How the market could know it perfectly, indeed? On this basis, the further question is then: what do securities markets do? Unequivocally, they are institutional devices that allow trading on shares and other securities in the form of financial entitlements which are established by law and formalise expectations of and claims to financial rents. They might surely help in aggregating dispersed information (by matching heterogeneous opinions and needs), but, remembering the Latin adage, ignoramus et ignorabimus (we do not and we will not know), they cannot solve the ignorance dimension that characterizes the human condition, and favours moral hazard and abuse.

**Judicial sources**

Justh v. Holliday, 13 D.C. (2 Mackey) 346 (1883)

Melchert v. American Union Telegraph Co., 11 F. 193 (D. Iowa 1882)


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References
