Vanderbilt Law Review

Volume 41
Issue 3 *Issue 3 - April 1988*

Article 2

4-1988

The Exchange-Trading Requirement of the Commodity Exchange Act

William L. Stein

The Exchange-Trading Requirement of the Commodity Exchange Act

*William L. Stein**

I. Introduction

The Commodity Exchange Act (CEA)[1] makes it illegal to trade a contract for the purchase or sale of a commodity for future delivery—a "futures contract"—unless the contract is executed on a federally designated exchange.[2] Despite its long history of trouble-free administration and operation, this central premise of futures regulation recently has been attacked as unworkable and undesirable. Some argue that the requirement discourages commercially useful off-exchange transactions.[3] They claim that even if such transactions fall within the letter of the requirement, off-exchange transactions do not implicate the trading restriction's policy concerns.[4] In contrast, others suggest that off-exchange

---

* J.D., Northwestern, 1983; M.A., Econ., Northwestern, 1984; A.B., Oberlin, 1978. Mr. Stein is associated with the law firm of Kirkland & Ellis in Chicago, Illinois.

1. 7 U.S.C. §§ 1-26 (1982) (as amended).

2. *Id.* § 2.

3. *See* Gerstell, *Developments in Off-Exchange Financial Products*, 21 Rev. Sec. & Commodities Reg. 1 (1988); Karr, *Climb in Off-Exchange Futures Sales Challenges CFTC*, Wall St. J., Mar. 3, 1987, at 10, col. 1.

4. *See, e.g.*, Gilberg, *Regulation of New Financial Instruments Under the Federal Securities and Commodities Laws*, 39 Vand. L. Rev. 1599 (1986); Schroeder, *Will Off-Exchange Contracts*

transactions threaten the safety and soundness of the international financial system,[5] and violate the clear language of the CEA. The outcome of this debate will have a profound impact on risk management and the futures industry for years to come.

The purpose of this Article is to review this longstanding and now controversial exchange-trading requirement—including its origins, scope, and current relevance. Parts II and III of this Article examine the historical evolution of forward and futures contracts and present an overview of federal regulation of commodity futures from 1921 to the present. Part IV explores in detail the legislative history of the exchange-trading requirement. Particular emphasis is placed on the meaning of a narrow statutory exception to the requirement called the "forward contract exclusion." In Part V the "Treasury Amendment," adopted in 1974, is reviewed and determined to be a clarification of the forward contract exclusion. Following an examination of the Commodity Futures Trading Commission's jurisdiction over futures trading in Part VI, Part VII analyzes a proposal to carve out a "safe harbor" from the exchange-trading requirement for futures transactions by commercial institutions. That section concludes that the proposal finds no support in the language or legislative history of the CEA and ignores important congressional policy considerations. Overall, this Article finds that the CEA, as presently structured, appropriately determines what instruments must be traded on desiguated exchanges and accommodates all commercially useful transactions.[6]

II. The Evolution of Futures Trading in the United States

The first commodity markets in the United States appeared during the late eighteenth century.[7] These regional cash or "spot" markets provided little more than gathering places for producers, processors, and consumers.[8] Although these markets aided the distribution of goods by uniting buyers and sellers interested in immediate cash transactions, a serious problem remained for the grain farmer. Since most farmers sold

---

Set Off Industry Civil War?, FUTURES, Mar. 1987, at 54; Schroeder, *Inadvertent Futures Contracts*, 19 REV. SEC. & COMMODITIES REG. 89, 90-91 (1986); *The Forward Contract Exclusion: An Analysis of Off-Exchange Commodity-Bases Instruments*, 41 BUS. LAW. 853 (1986).

5. *See* Fin. Times, Dec. 10, 1986, at 25, col. 1; N.Y. Times, Oct. 17, 1986, at D1, col. 1.

6. The scope of this Article is limited to an examination of futures contracts and the statutory requirement that they be traded only on federally designated exchanges. Commodity options and leverage contracts, which are governed by distinct statutory provisions, are not discussed suhstantively.

7. *See* S. REP. No. 384, 97th Cong., 2d Sess. 9 (1982).

8. Although these early markets traded eggs, butter, vegetables, and other commodities, the remainder of the discussion in this section will concentrate on grain markets because of their special role in the evolution of futures trading.

the bulk of their production at harvest time, brokers and millers reduced their bids because supply greatly exceeded their short-term needs. During times when the market could not absorb the seasonal glut at any price, grain was dumped on the streets. Yet several months after a harvest, shortages developed, prices soared, and people starved. Businesses sputtered for lack of raw materials.[9] Storage facilities were built to solve this distribution problem. Storage elevators enabled farmers to hold their grain until an acceptable price was available. These facilities also enabled millers and other users to inventory grain for future use.

The first forward contracts were a natural consequence of limited storage space, spasmodic demand for cash grains, and inefficient transportation systems. Occasionally a large buyer could not satisfy his commitments with the grain in stock at a terminal market. He would then contract to buy the needed grain from nearby rural sellers. Because it often took several days to transport the grain from the countryside to the terminal market, the contracts called for delivery of the cash grain within some fixed period of time, *i.e.*, "to-arrive" at the terminal market in five days, one week, etc.[10] Similarly, commodities loaded onto ships were sold "to-arrive" at distant ports in several weeks or months.[11] By the 1850s, buyers and sellers recognized the utility of forward contracting not only as a method of allowing for transportation time, but as a general method of merchandising a seasonal crop.[12]

The benefits of forward contracting were numerous. Brokers and processors could assure themselves of supplies without investing directly in storage. Moreover, forwarding allowed farmers to sell grain they expected to harvest and brokers to sell inventories they expected to acquire. These transactions facilitated the efficient distribution of grain over time by managing the temporal supply of grain with merchandising contracts for actual grain.[13]

Futures contracts developed as a solution to a very different problem. A declining market meant that executory agreements (such as "to-

---

9. Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Curran, 456 U.S. 353, 357 (1982); S. REP. No. 384, 97th Cong., 2d Sess. 10 (1982).

10. 1 C. TAYLOR, HISTORY OF THE BOARD OF TRADE OF THE CITY OF CHICAGO 193 (1917).

11. *See In re* First Nat'l Monetary Corp., [1982-1984 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 21,707, at 26,773 (C.F.T.C., Apr. 29, 1983), *rev'd*, [1984-1986 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 22,698 (C.F.T.C., Aug. 7, 1985).

12. *Cf.* 1 C. TAYLOR, *supra* note 10, at 192-93, 206-08, 217, 256.

13. "To-arrive" contracts apparently were not uncommon in Chicago even as it took its first steps toward becoming a major grain marketing center. In the same issue announcing formation of the Chicago Board of Trade, the Chicago Daily Journal reported in its trade and commerce column: "We hear of a sale of 5,000 bushels corn to arrive in May, on private terms." *Id.* at 138 (citing Chicago Daily Journal, Apr. 1, 1848).

arrive" contracts) were more valuable to sellers than the commodities covered by the contracts because the commodities could be purchased in the spot market for less than the contract prices. In a rising market, however, executory contracts held special value for buyers, who not only were assured of delivery of the commodity but also could derive a profit from price increases.[14]

If grain prices remained relatively stable, commercial interests assumed little risk by holding inventories, little opportunity existed for speculative profit, and little danger existed for speculative loss. The 1850s and 1860s, however, produced anything but stable commodity prices. In particular, the suspension of payments in specie by the United States Treasury and its introduction of greenbacks as the primary medium of exchange brought on an era of paper currency discounting, which fundamentally affected the conduct of all business. Greenbacks and gold specie were not treated as comparable stores of value. In effect a twenty dollar greenback was worth less than a twenty dollar gold coin. This discounting was tied to the "gold premium," which fluctuated with the fortunes of the Union forces during the United States Civil War, increasing with setbacks and decreasing with victories. As the gold premium fluctuated, so too did the price of goods. Any accurate forecast of future grain prices included an implicit prediction of the gold premium.[15]

Other events also worked fundamental changes on the markets. The Crimean War, recurring crop failures, and the continuing development of farmlands in the Northwest Territories and lands west of the Mississippi prompted much speculation and uncertainty in the supply of, and demand for, foodstuffs.[16] These factors made it risky to hold grain inventories. Brokers in Chicago who had to store grain when the Great Lakes were closed to shipping (and when market liquidity was thin) recognized that the value of their inventories often changed before they could sell the commodities to buyers on the Eastern Seaboard or in Europe.[17] While many merchants were more than happy to speculate on the value of their stocks of grain, others simply wanted to secure a fair return on their investment and labor. Futures contracts evolved to permit the transfer of unwanted price risk from these risk averse merchants to those more willing or better able to bear such risk.[18]

---

14. *Curran*, 456 U.S. at 357.

15. C. TAYLOR, *supra* note 10, at 306-07, 316.

16. *Id.* at 192-323.

17. *Id.* at 147.

18. *Cf. In re* First Nat'l Monetary Corp., [1982-1984 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 21,707, at 26,773 (C.F.T.C., Apr. 29, 1983), *rev'd*, [1984-1986 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 22,698 (C.F.T.C., Aug. 7, 1985).

III. An Overview of Federal Futures Regulation

In the early twentieth century, the perception that large speculators on grain exchanges manipulated prices to the detriment of producers and consumers fueled a populist movement to regulate or abolish futures trading. The movement's efforts culminated in enactment of the Future Trading Act of 1921 (FTA).[19] The statute's primary purpose was to regulate the boards of trade on which futures trading occurred in order to prevent the price manipulations that many believed resulted from excessive speculation.[20] Congress, through the FTA, also sought to destroy bucket shops,[21] which were businesses that offered small investors the opportunity to speculate on the price of commodities. Customers wagered on the fluctuation of exchange prices in private, unreported deals. The bucket shops matched customer orders against each other and assumed the risk of any net positions. When the market moved against the shops, they usually closed in haste and their owners disappeared, leaving customers with uncollectable claims.[22]

Congress acknowledged the legitimacy of futures contracts as risk shifting devices essential to the marketing of grain. It also recognized the need for speculative capital to provide liquidity to the markets, yet Congress sought to channel and control the speculative instincts of investors.[23] This goal would be accomplished by monitoring the exchanges' oversight of their members and by imposing a prohibitive tax on all futures trading conducted outside federally designated exchanges. Federal designation hinged on the exchanges' continued compliance with various provisions designed to insure fair and efficient conduct of business, particularly the elimination of manipulation.

---

19. Future Trading Act of 1921, Pub. L. No. 67-66, 42 Stat. 187; *see infra* note 24 and accompanying text (key provision of Act later declared unconstitutional).

20. H.R. Rep. No. 44, 67th Cong., 1st Sess. 2 (1921) (stating that "while [this measure] will not abolish speculation, or what is known to the trade as the 'legitimate hedge,' it will absolutely destroy manipulation"); *see also* 61 Cong. Rec. 1317 (1921) (remarks of Rep. Purnell) (stating that "[t]he one overshadowing evil that must be eliminated is manipulation").

21. *See, e.g.*, 61 Cong. Rec. 1318 (1921) (remarks of Rep. Voight) (stating that "[t]he bucket shop is wiped out in this bill, because a bucket shop is not a contract market"); 132 Cong. Rec. S17023 (daily ed. Oct. 17, 1986) (remarks of Sen. Melcher) (stating that "[t]he mayhem caused by commodity bucket shops is what caused Congress, over 60 years ago, to create a broad futures contract definition and require all lawful futures to be traded on federally approved exchanges").

22. *See* C. Cowing, Populists, Plungers, and Progressives 27-28 (1965). For a comprehensive study of bucket sbops, see J. Hill, Gold Bricks of Speculation (1975 reprint of 1904 ed.).

23. *See, e.g.*, *Future Trading: Hearings Before the House Comm. on Agriculture*, 66th Cong., 3d Sess. 1043 (1921); *Future Trading in Grain: Hearings on H.R. 5676 Before the Senate Comm. on Agriculture and Forestry*, 67th Cong., 1st Sess. 452 (1921); 61 Cong. Rec. 4761 (1921) (remarks of Sen. Capper) [hereinafter *Senate Hearings on Future Trading*]; 132 Cong. Rec. S15283 (daily ed. Oct. 7, 1986) (remarks of Sen. Moynihan) (stating that "[y]ears ago, Congress decided to harness [speculative impulses] by requiring all commodity futures contracts to be traded openly and competitively on federally approved exchanges").

In 1922 the Supreme Court declared a key provision of the FTA an improper exercise of the taxing power.[24] Congress responded with the Grain Futures Act of 1922 (GFA),[25] which recognized the same benefits, and attempted to curtail the same perceived speculative abuses, of futures trading, but this time through the exercise of congressional power under the Commerce Clause.[26] Except for the addition of certain definitions and a new section declaring that futures trading was "affected with a national public interest," the GFA contained no material changes from the regulatory provisions of the FTA.[27] With the removal of the FTA's unconstitutional reliance on the taxing power, the Supreme Court upheld the statute.[28]

In 1936 Congress amended the GFA extensively and renamed it the Commodity Exchange Act (CEA).[29] The legislation extended regulatory coverage to additional commodities, gave a commission the power to impose speculative position limits, outlawed various fraudulent activities, and added to the arsenal of sanctions available to punish violators. In enacting the CEA, Congress emphasized again the paramount policy concerns of preventing manipulation and of outlawing bucket shops.[30] Following some minor changes in 1968,[31] the CEA was amended extensively in 1974.[32] The amendments expanded the definition of "commodity," created the Commodity Futures Trading Commission (CFTC), and granted the CFTC exclusive jurisdiction over futures trading. Since 1974, the CEA has been amended in 1978,[33] 1982,[34] and 1986.[35]

---

24. Hill v. Wallace, 259 U.S. 44 (1922).

25. Grain Futures Act of 1922, Pub. L. No. 67-331, 42 Stat. 998 (codified as amended at scattered sections of 7 U.S.C. §§ 1-26 (1982 & Supp. IV 1986)).

26. S. REP. No. 871, 67th Cong., 2d Sess. 3 (1922).

27. H.R. REP. No. 1095, 67th Cong., 2d Sess. 2-3 (1922); *see also* Regulation of Leverage Contracts, [1977-1980 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 20,772, at 23,168 (C.F.T.C., 1979).

28. Board of Trade of Chicago v. Olsen, 262 U.S. 1 (1923).

29. Commodity Exchange Act of 1936, Pub. L. No. 74-675, 49 Stat. 1491 (codified as amended at scattered sections of 7 U.S.C. §§ 1-26 (1982 & Supp. IV 1986)).

30. For example, fear was expressed that, absent further regulation, large speculators from the newly regulated securities markets would flock to the commodities markets and increase the risk of manipulations. *See, e.g., Commodity Exchange Act: Hearings on H.R. 9623 Before the House Comm. on Rules*, 73d Cong., 2d Sess. 8 (1934).

31. Act of Feb. 19, 1968, Pub. L. No. 90-258, 82 Stat. 26 (codified as amended in scattered sections of 7 U.S.C. §§ 1-26 (1982 & Supp. IV 1986)).

32. Commodity Futures Trading Commission Act of 1974, Pub. L. No. 93-463, 88 Stat. 1389 (codified as amended in scattered sections of 7 U.S.C. §§ 1-26 (1982 & Supp. IV 1986)).

33. Futures Trading Act of 1978, Pub. L. No. 95-405, 92 Stat. 865 (codified as amended in scattered sections of 7 U.S.C. §§ 1-26 (1982 & Supp. IV 1986)).

34. Futures Trading Act of 1982, Pub. L. No. 97-444, 96 Stat. 2294 (codified as amended in scattered sections of 7 U.S.C. §§ 1-26 (1982 & Supp. IV 1986)).

35. Futures Trading Act of 1986, Pub. L. No. 99-641, 100 Stat. 3556 (codified as amended in scattered sections of 7 U.S.C. §§ 2-23 (Supp. IV 1986)).

IV. THE EXCHANGE-TRADING REQUIREMENT

The CEA prohibits the solicitation or acceptance of an order for, or otherwise dealing "in, or in connection with, a contract for the purchase or sale of a commodity for future delivery," unless the transaction is conducted on, or subject to the rules of, a federally designated contract market.[36] This provision, which is the cornerstone of all futures regulation,[37] first appeared in a slightly different form in a draft of the FTA. The House version of the FTA would have imposed a prohibitive tax "upon each contract of sale of grain for future delivery *made at, on, or in an exchange, board of trade, or similar institution or place of business*, except . . . where the contracts are made by or through a member" of a federally designated contract market.[38]

The Senate, however, feared that this wording would not prohibit bucket shops. It recognized the ingenuity of unscrupulous businessmen and the opportunity that the language of the House bill would create for scoundrels and con artists to develop private off-exchange futures contracts—contracts technically not within the language of the bill because the contracts would not be made "at, on, or in an exchange."[39] For these reasons, the preceding emphasized langnage was removed. The House agreed to its removal in the conference committee.

For reasons now obscure, the GFA (restyled the CEA in 1936) did not adopt the same wording. Section 4 of the statute outlawed transactions in "any contract of sale of grain for future delivery *on or subject to the rules of any board of trade in the United States* . . . except . . . where such contract is made by or through a member of [a federally designated contract market]."[40] The inclusion of this langnage, particularly in light of the wranglings over similar language in the FTA, could be interpreted as an indication that Congress intended the exchange-trading requirement to extend only to contracts made on "any board of

---

36. 7 U.S.C. § 6a(1) (1982). Knowing violations of the requirement are punishable by criminal fines and imprisonment. *Id.* § 13(b).

37. *Cf. In re* Stovall, [1977-1980 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 20,941, at 23,781 (C.F.T.C., Dec. 6, 1979); 132 CONG. REC. S15283 (daily ed. Oct. 7, 1986) (remarks of Sen. Moynihan) (stating that the exchange-trading requirement is the "founding principle of Federal futures law").

38. H.R. 5676, 67th Cong, 1st Sess. § 4 (1921) (as passed by the House and referred to the Senate Agriculture and Forestry Committee) (emphasis added). See *infra* notes 73-112 and accompanying text for a more detailed discussion of the 1921 definitional debate.

39. Congressional concerns over loopholes in the CEA that might create incentives to trade futures off-exchange remain to this day. *See* 132 CONG. REC. S17023 (daily ed. Oct. 17, 1986) (remarks of Sen. Melcher) (stating that "[w]e do not want unscrupulous con artists and bucket shop operators to seize this inadvertent loophole [— the provision for off-exchange leverage trading —] and design other nonfutures contracts that will not need to be traded on exchanges").

40. Grain Futures Act of 1922, Pub. L. No. 67-331, § 4, 42 Stat. 998, 999 (current version at 7 U.S.C. § 6(a) (1982) (emphasis added)).

trade in the United States."

The CFTC, however, has pointed out that "[s]uch an interpretation would leave untouched any private exchange or bucket shop operation which is arguably not a board of trade" and would thereby undercut the central objective of futures regulation—to require *all* contracts of sales in regulated commodities to be executed on designated exchanges.[41] Consequently, the CFTC "unequivocally" has reaffirmed "that all contracts for the sale of commodities for future delivery [must] be executed . . . on a contract market designated by this Commission."[42] Courts uniformly have reached the same conclusion.[43]

Another weakness in section 4 of the CEA was that, while it required a member of a designated exchange to execute all contracts of sale of a commodity for future delivery, it did not specify literally that the contracts had to be executed through the facilities of a contract market. Thus, the statute could have been read to permit exchange members to buy and sell futures contracts off-exchange. This interpretation, however, also has been rejected as contrary to congressional intent.[44] Generally, courts have interpreted section 4 broadly to require that all trading of futures contracts occur on designated exchanges.

Other provisions of the CEA support this conclusion. In 1936 Congress added two new sections addressing the question of off-exchange practices. Section 4h made it unlawful for any person

> to conduct any office or place of business anywhere in the United States or its territories for the purpose of soliciting or accepting any orders for the purchase or sale of any commodity for future delivery, or for making or offering to make any contracts for the purchase or sale of any commodity for future delivery, or for conducting any dealings in commodities for future delivery . . . if such orders, contracts, or dealings are executed or consummated otherwise than by or through a

---

41. *In re* Stovall, [1977-1980 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 20,941, at 23,781 (C.F.T.C., Dec. 6, 1979). The CFTC here addressed statutory language (in force between 1968 and 1982) substantively similar to that of section 4 of the GFA. *See infra* notes 45-52 and accompanying text.

42. *Id.*

43. *See* Commodity Futures Trading Comm'n v. Co Petro Mktg. Group, Inc., 680 F.2d 573, 576-79 (9th Cir. 1982); Commodity Futures Trading Comm'n v. Commercial Petrolera Internacional, S.A., [1980-1982 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 21,222, at 25,088 (S.D.N.Y. June 26, 1981); *In re* First Nat'l Monetary Corp., [1982-1984 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 21,707, at 26,776 (C.F.T.C., Apr. 29, 1983), *rev'd on other grounds*, [1984-1986 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 22,698 (C.F.T.C., Aug. 7, 1985). In *Co Petro* the Ninth Circuit took a slightly different approach, concluding that the term "board of trade" as used in § 4's phrase "on or subject to the rules of any board of trade" was "broad enough to encompass Co Petro's [off-exchange] activities here." *Id.* at 581.

44. See, for example, *Stovall*, [1977-1980 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 20,941, in which the respondent was a member of two contract markets when he executed the challenged off-exchange futures contracts. Following an exhaustive analysis of the legislative history of § 4, as well as the history of futures trading in general, the CFTC concluded "that Congress could not have intended such a narrow application." *Id.* at 23, 782 n.28.

member of a contract market.[45]

This section prohibited "operation of a place of business where orders for futures contracts are solicited or accepted unless such orders are to be executed by or through a member of a contract market."[46] Read literally, the section continued the earlier pattern of loose legislative draftsmanship. It required only that futures contracts be executed or consummated by a member of a contract market, although not necessarily through the facilities of a contract market.

Section 4b was enacted at the same time, and prohibited members of a contract market from "bucketing" customer orders.[47] "Bucketing" included any transaction in which the member assumed the other side of his customers' orders, or matched customer orders against each other. The evil of bucketing was that it sidestepped the competitive open outcry auctions which take place on the floors of exchanges.[48] Taken together, these sections prohibited all off-exchange futures trading: Section 4h required future-delivery business to be conducted through a member of a contract market and section 4b required contract market members to conduct future-delivery business through the facilities of a designated contract market.

Unfortunately, Congress could not leave well enough alone and amended section 4b in 1968 to expand the application of its bucketing prohibition beyond contract market members to "any person."[49] In so doing, it inadvertently restructured the section in a way that created the same linguistic ambiguity which existed prior to 1936.[50] In 1982 Congress eliminated the ambiguity again when it adopted the CFTC's recommendation to combine sections 4 and 4h into the current section 6(a), which makes it unlawful for any person to transact in "a contract for the purchase or sale of a commodity for future delivery . . . unless . . . such transaction is conducted on or subject to the rules" of a federally designated contract market.[51] By requiring all futures to be exe-

45. Commodity Exchange Act of 1936, Pub. L. No. 74-675, § 5, 49 Stat. 1491, 1496 (current version at 7 U.S.C. § 6(a) (1982)).

46. H.R. REP. No. 421, 74th Cong., 2d Sess. 6 (1935).

47. Commodity Exchange Act of 1936, Pub. L. No. 74-675, § 5, 49 Stat. 1491, 1493 (current version at 7 U.S.C. § 6(a) (1982)).

48. *See* 80 CONG. REC. 8088 (1936) (document discussing trade terminology offered into record by Sen. Pope) (stating that "[bucketing and bucket shops] are terms used to describe a method of doing business wherein orders of customers for the purchase or sale of commodities for future delivery, instead of being executed by bona-fide purchases and sales with other traders, are simply matched and offset in the soliciting firm's own office and the firm itself takes the opposite side of customers' orders").

49. S. REP. No. 947, 90th Cong., 2d Sess. 6 (1968).

50. Congressional intent to require that all futures transactions take place on designated exchanges apparently did not change. *See* S. REP. No. 1131, 93d Cong., 2d Sess. 16 (1974).

51. 7 U.S.C. § 6(a) (1982).

cuted on contract markets, Congress ended any speculation that members of contract markets could conduct off-exchange futures business.

The CFTC has consistently interpreted the CEA to prohibit all off-exchange futures contracts. In 1979 it issued a proposed statutory interpretation that concluded:

> Congress has evinced a strong intention to regulate all persons engaged in the business of buying, selling, offering, accepting and otherwise dealing in contracts for the future delivery of commodities, and has done so by requiring that no such business may be conducted unless it . . . is conducted *through the facilities of an exchange* that has met the criteria for designation by the Commission as a contract market. *Any public offering of these contracts other than through the facilities of a designated contract market is unlawful.*[52]

Courts and commentators have construed the CEA similarly to require exchange trading of all futures contracts.[53]

A. *The Policy Behind the Exchange-Trading Requirement*

Restricting futures trading to designated exchanges is supported by unequivocal statutory language (certainly since 1982), CFTC interpretations and decisions, federal court holdings, and sound policy considerations.[54] Unlike unregulated over-the-counter markets, futures exchanges provide centralized liquid markets that promote price discovery. Unlike unregulated over-the-counter markets, exchanges must demonstrate that the contracts they trade will not be contrary to the public interest and must make an elaborate CFTC-required showing that these contracts serve an underlying economic purpose other than mere speculation.[55] In addition, unlike unregulated over-the-counter markets,

52. Regulation of Leverage Transactions as Contracts for Future Delivery or Otherwise, [1977-1980 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 20,772, at 23,170 (C.F.T.C., Mar. 12, 1979) (emphasis added); *see also In re* Stovall, [1977-1980 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 20,941 (C.F.T.C., Dec. 6, 1979).

53. *Cf.* Merrill Lynch, Pierce, Fenner & Smith v. Curran, 456 U.S. 353, 361 n.14 (1982); Commodity Futures Trading Comm'n v. Co Petro, 680 F.2d 566, 582 n.14 (9th Cir. 1982); First Nat'l Monetary Corp. v. Commodity Futures Trading Comm'n, 677 F.2d 522 (6th Cir. 1982); Commodity Futures Trading Comm'n v. National Coal Exch., Inc., 624 F. Supp. 154 (S.D.N.Y. 1985); *see also* Schroeder & Pollock, *Commodities Regulation*, 8 REV. SEC. REG. 935, 936 (1975) (stating that "[t]he Commodity Exchange Act contemplates that all futures trading in the U.S. will take place on regulated exchanges—in other words, there will be no over-the-counter market in futures"); Representative Dan Glickman, FUTURES, Sept. 1985, at 38 (stating that "commodity futures law restricts futures trading to organized, federally sanctioned exchanges, a restriction which should remain in effect for now"); 132 CONG. REC. S13586 (daily ed. Sept. 25, 1986) (remarks of Sen. Dixon) (stating that "all futures contracts, regardless of the underlying commodity, must be traded on federally approved exchanges"); Phillips, *Viable and Safe Markets—The Role of the Commodity Futures Trading Commission*, Nat'l J., 1814, 1815 (Sept. 3, 1983) (stating that "federal law prohibits the trading of futures contracts any place other than on a designated exchange").

54. *See generally Curran*, 456 U.S. at 358-59.

55. 7 U.S.C. § 7a (1982); Revised Guidelines on Economic and Public Interest Requirements

exchanges promulgate, administer, and enforce rules designed to ensure honest markets and the integrity of their members.[56]

Integrity is promoted in several ways. First, exchanges assure the satisfaction of all financial obligations through financial safeguards, which insure performance by market participants. Margin requirements and daily marking-to-market help reduce the risk of nonperformance by securing obligations to perform in the future and by adjusting the margined amounts on a daily basis to conform with changing market values.[57] Minimum capitalization requirements provide investors with assurance that futures commission merchants (FCMs) will not default.[58] In the unlikely event of a default, fund segregation requirements insure that proprietary FCM losses will not have an adverse impact on customer capital. Similarly, clearing corporations, by taking an opposite position on each trade, reduce the risk of performance default.[59]

The recent collapse of several government securities firms graphically illustrates the dangers created by the absence of such financial protections. For example, the failure of ESM Government Securities led to direct losses for a number of commercial firms, municipalities, and savings and loan associations—all of whom were considered large and sophisticated players in the market.[60] Perhaps more distressing were the widespread repercussions that the failure had on innocent third parties. The loss of confidence in Home State Savings Bank of Cincinnati, a creditor of ESM, touched off a run on state insured institutions, which ultimately led the Governor of Ohio to declare a bank holiday.[61] This crisis raised doubts about the stability of the entire United States

---

for Contract Market Designation, 1 Comm. Fut. L. Rep. (CCH) ¶ 6146 (Nov. 3, 1982).

56. 7 U.S.C. § 7a(8) (1982).

57. Futures contracts are not assets and do not have monetary value in the same sense as securities. They give purchasers the right to profit from favorable market moves and the obligation to pay as a result of unfavorable market moves. Futures margins secure the purchaser's obligation to pay. Securities margins, on the other hand, act as down payments on the securities.

58. An FCM is an individual, association, partnership, corporation, or trust "engaged in soliciting or in accepting orders for the purchase or sale of any commodity for future delivery on or subject to the rules of any contract market and that, in or in connection with such solicitation or acceptance of orders, accepts any money, securities, or property (or extends credit in lieu thereof) to margin, guarantee, or secure any trades or contracts . . . therefrom." 7 U.S.C. § 2 (1982); *see also* 17 C.F.R. § 1.3 (1987).

59. Irrespective of these measures, a massive off-exchange default could lead to a loss of confidence in the markets for exchange-traded products. Such externalities demonstrate that exchanges have an interest in the conduct of off-exchange business over and above fears of unfair competition. *See* Architzel & Tosini, *A Framework For Current Issues Regarding Off-Exchange Instruments*, 7 COMMODITIES L. LETTER, Apr. 1987, at 5.

60. *See* Brannigan, *ESM Collapse Prompts S & P to Add 4 More Municipalities to Credit Watch*, Wall St. J., Mar. 8, 1985, at 10, col. 1; *see also Closing of Ohio S & Ls After Run on Deposits is One for the Books*, Wall St. J., Mar. 18, 1985, at 1, col. 6.

61. *See* Brannigan, *supra* note 60; *Closing of Ohio S & Ls After Run on Deposits is One for the Books, supra* note 60.

banking system among foreign investors, producing a sudden drop in the value of the dollar and a sharp rise in the price of precious metals.[62]

This rise in the price of precious metals, in turn, contributed to the collapse of a futures exchange clearing firm when several of its customers—and ultimately the firm—could not satisfy margin calls on a large number of short gold options.[63] The failure temporarily dislocated the financial affairs of numerous customers who had no connection to the short gold option positions or ESM Government Securities. Thus, the fraudulent activities of an off-exchange government securities firm contributed to the serious financial distress inflicted upon innocent savings and loan depositors and holders of regulated futures instruments.[64]

Exchanges do more than promote financial integrity. National and international businesses rely on prices discovered on exchanges to reflect an equilibrium between supply and demand, not other artificial factors.[65] Self-interested traders monitor each other constantly and serve as the first line of defense against manipulation. Exchanges monitor the activities of their members and review market behavior regularly for suspicious signs, interceding through disciplinary actions and rule making. The CFTC also monitors trading, and its oversight is facilitated by the concentration of activity on an exchange in contrast to widely dispersed trading among private firms and individuals in unlicensed, nomadic shops, or on impersonal electronic trading systems.

Moreover, businesses rely on the prices discovered on the exchanges as being a reflection of the opinions and expectations of a broad base of knowledgeable market participants. Market makers, each with their own private information, bid on arriving orders, and their collective information is incorporated into each changing price. Dilution of trading caused by unreported private off-exchange trading would im-

---

62. O'Connor, *Ohio's Banking Crisis, Prospects for Inflation Spark Gains in Prices*, Wall St. J., Mar. 19, 1985, § 2, at 46, col. 3.

63. Sullivan, *Comex Member Firm's Collapse Affects 75 Investors, Broker, Other Exchanges*, Wall St. J., Mar. 25, 1985, § 2, at 42, col. 3.

64. The example illustrates the weakness of the argument that commercial interests should he free to transact in off-exchange instruments because the commercials can afford to assume the risk that they will have to pay a penalty for had business decisions or sloppy monitoring against fraud. Today's interdependent markets increase the risk of a "snowballing" financial disaster and no longer permit enclaves of unfettered and unregulated deal making. *See infra* notes 164-75 and accompanying text; *see also* 2 P. ARCHITZEL & P. TOSINI, A FRAMEWORK FOR CURRENT ISSUES REGARDING OFF-EXCHANGE ISSUES 9 (Ninth Annual Commodities Law Institute 1986) (stating that "there may be ripple effects in the economy at large from failure of firms in the off-exchange environment"); Nash, *Mending Financial Safety Net*, N.Y. Times, Oct. 7, 1986, at D1, col. 3.

65. *See* 7 U.S.C. § 5 (1982) (stating that "[t]he prices involved in [futures] transactions are generally quoted and disseminated throughout the United States and in foreign countries as a basis for determining the prices to the producer and the consumer of commodities and the products and byproducts thereof and to facilitate the movements thereof in interstate commerce"); *see also* 120 CONG. REC. 30459 (1974) (remarks of Sen. Talmadge).

pair the reliability of commodity prices. Further, by concentrating market makers in a single area, exchange trading increases liquidity and reduces the transaction costs of entering futures contracts, which makes hedging less expensive. Lower middlemen costs benefit producers and consumers. Thick markets also hinder attempted manipulations. In addition, well capitalized and competitive market makers enable hedgers and speculators to execute large orders with virtually no delay. This minimizes the risk that new information will affect prices adversely before the orders are filled, or that the large orders themselves will cause prices to either skyrocket or plummet.[66]

These public benefits are not available in a fragmented off-exchange trading environment. Accordingly, the CEA renders it illegal to transact in "a contract for the purchase or sale of a *commodity for future delivery*," unless the transaction is conducted on or subject to the rules of a federally designated contract market.[67] The statutory evolution of this exchange-trading requirement supports the CFTC's and the courts' broad application of the requirement. The requirement is also supported by sound policy considerations. The next two sections of the Article scrutinize the meaning of the requirement's key concepts—"commodity" and "future delivery."

B. The Meaning of "Commodity" Under the CEA

Prior to 1974, "commodity" was a narrowly defined term under the CEA, limited to those goods enumerated in the statute. In 1974 Congress fundamentally altered the scope of the CEA by expanding the definition to include additionally "all other goods and articles . . . and all services, rights and interests in which contracts for future delivery are presently or in the future dealt in."[68]

The provision was designed to provide hedgers and investors in "world commodity" futures with the same protection as hedgers and investors in the enumerated commodities.[69] Congress reasoned that the dangers of manipulation and the advantages of exchange trading applied equally to all commodities.[70] Moreover, Congress recognized the need for an open-ended definition that would capture the emerging fu-

66. S. GROSSMAN & M. MILLER, THE DETERMINANTS OF MARKET LIQUIDITY (Working Paper Feb. 1987).

67. 7 U.S.C. § 6(a)(1) (1982) (emphasis added).

68. Commodity Futures Trading Commission Act of 1974, Pub. L. No. 93-463, § 201(b), 88 Stat. 1389, 1395 (codified as amended at 7 U.S.C. § 2 (1982)); *see also* 17 C.F.R. § 1.3(e) (1987).

69. The House Committee on Agriculture noted "that the implementation of this provision would significantly increase public confidence in the futures market by providing the same protection to the unregulated commodity customers that is now afforded the regulated commodity customers." H.R. REP. No. 93-975, 93d Cong., 2d Sess. 62 (1974).

70. *Id.* at 41-42.

tures markets in financial products and indices as well as innovative products in non-traditional goods and services.[71]

The CEA now considers all "goods and articles" to be commodities. Furthermore, all "services, rights, and interests" underlying contracts for future delivery also qualify as commodities. The "services, rights, and interests" clause may be read literally to include services, rights, and interests as commodities only if they underlie an exchange-traded futures contract. This would imply that off-exchange futures trading involving, for example, rights or interests in a stock index is permissible so long as that index did not underlie an exchange-traded futures contract. But, under CEA section 2(a)(1)(A), "services, rights, and interests" become commodities when they are traded in contracts for future delivery, not when they are traded in contracts transacted on designated exchanges. Accordingly, a proper reading of the CEA would find that all services, rights, and interests traded in contracts for future delivery—whether on- or off-exchange—are commodities.

Further, the literal approach should be rejected as were earlier (pre-1982) arguments advocating a literal reading of sections 4 and 4h. The allegedly literal readings are inconsistent with the CEA's general concern with private exchanges and bucket shops and the explicit intent of Congress to extend the protection of the CEA to buyers and sellers of *all* futures contracts, whether on- or off-exchange, in enumerated commodities or former world commodities. "Services, rights, and interests" should be interpreted to advance the broad remedial purposes of the CEA.[72]

C. *The Meaning of "Future Delivery" Under the CEA*

The term "future delivery" first appeared in the FTA, but its origin may be traced back to H.R. 2363, the 1921 bill that Congress eventually enacted in modified form as the FTA. The crux of the bill, contained in section 4, proposed to levy a tax "upon each [bushel of grain involved in a] contract of sale of grain for future delivery, except . . . where the seller is at the time of the making of such contracts the owner of the actual physical property covered thereby" ("the Owners/Growers exemption").[73] A second clause removed the tax on contracts for the sale of grain for future delivery "when made by or through a member of a board of trade which had been designated by the Secre-

71. *Id. See generally* Board of Trade of Chicago v. SEC, 677 F.2d 1137, 1142-43 (7th Cir.), *vacated*, 459 U.S. 1026 (1982).

72. *See generally* Architzel & Connolly, *Delivery on Futures Contracts As a Legal Requirement*, 36 Bus. Law. 935, 936-39 (1981).

73. H.R. 2363, 67th Cong., 1st Sess. § 4(a) (1921).

tary of Agriculture as a contract market."[74] Such designation was authorized only when the board of trade agreed to comply with certain requirements.[75]

The House Agriculture Committee held extensive hearings on the bill. Near the end of those hearings, Secretary of Agriculture Henry C. Wallace suggested adding the words "made at, on, or in an exchange, board of trade or similar institution or place of business" after the words "future delivery" and before the word "except," in the introductory clause to the section (the "Wallace Amendment").[76] Mr. Wallace explained that the proposed amendment sought merely to clarify that the tax applied only to transactions for future delivery executed on exchanges. He cited as an example the sale of actual grain to an exporter or foreign buyer by members of a cooperative selling agency whose members had not yet planted the crop. Because the grain did not yet exist, Wallace argued, the cooperative could not escape the prohibitive tax through the Owners/Growers exemption because the exemption applied only if the seller owned the actual physical commodity at the time the contract was made.[77] The cooperative could not escape the tax through the second clause because the contract would not be executed by or through a member of a designated contract market.[78] By adding the language restricting the tax to contracts made on exchanges, the Secretary hoped to avoid the unintended taxation of a privately negotiated forward contract used for merchandising purposes.[79] When asked whether such language would permit undesirable off-exchange speculation, the Secretary responded that the intent was to permit unrestricted contract making for future delivery of actual grain only.[80] Chester Morrill, a staff member of the Department of Agriculture, later commented that the additional wording was needed to avoid granting members of boards of trade an unintended monopoly on futures *and forward contracts*, both of which were literally contracts of sale for delivery of grain in the future.[81]

---

74. *Id.* § 4(b).
75. *Id.* § 5.
76. *Future Trading: Hearings Before the House Comm. on Agriculture*, 67th Cong., 1st Sess. 326 (1921) [hereinafter *House Hearings on Future Trading*]. The Wallace Amendment would have caused § 4 to impose a tax "upon each [bushel of grain involved in a] contract of sale of grain for future delivery *made at, on, or in an exchange, board of trade or similar institution or place of business*, except where the seller is at the time of the making of such contracts the owner of the actual physical property covered thereby." The language originated in the United States Cotton Futures Act, Pub. L. No. 190, 39 Stat. 476 (1916).
77. *See supra* note 73 and accompanying text.
78. *See supra* note 74 and accompanying text.
79. *House Hearings on Future Trading, supra* note 76, at 338.
80. *Id.* at 339.
81. *Id.* at 344.

In the words of Mr. Morrill, the purpose of the amendment was to avoid

> the condition that any [person] who makes a contract which may be considered to be for future delivery of grain outside of a board of trade must do it nevertheless through a member of a board of trade, [giving] the members of boards of trade a monopoly of future grain business.[82]

Mr. Morrill used the term "futures" loosely (and confusingly) to include all future settling instruments. Contracts "of sale of grain for future delivery" and "what is technically known as futures trading" were distinguished.[83] The former encompassed exchange-traded futures as well as forward merchandising contracts for cash that occurred both on- and off-exchange. The latter was a technical term that encompassed the organized trading of standardized contracts that occurred (in 1921) only on futures exchanges.[84] The Committee approved the Wallace Amendment,[85] and the bill was passed by the full House and referred to the Senate Committee on Agriculture and Forestry.[86]

The Senate Committee also held hearings, during which the Wallace Amendment was extensively discussed. Mr. Morrill again explained that the amendment was intended to make the tax

> applicable to future trading as such, *wherever it might be conducted, as distinguished from transactions which might be made for forward delivery or forward shipment*, such, for example, as an exporter might enter into obligating himself to ship a certain amount of grain three months hence, which would be a transaction for future delivery, but which the Secretary thought was not really intended to be governed by this bill.[87]

He further explained that without the Wallace Amendment "the handling of the *cash grain business* for future delivery [would be taken] out of the hands of individuals and compel them to handle their business through boards of trade."[88]

It was later pointed out, however, that while the amendment clarified that the tax did not apply to cash transactions for deferred delivery, it did so in a way that could be construed to permit bucket shop operations. Arguably, the Wallace Amendment created an incentive for such operations by implying that grain for future delivery that was *not* "made at, on, or in an exchange" could change hands tax-free. A witness before the Senate committee argued that the tax would unmistaka-

82. *Id.*
83. *Id.*
84. *Id.*
85. *Id.* at 345.
86. 61 CONG. REC. 1429 (1921).
87. *Senate Hearings on Future Trading*, *supra* note 23, at 9 (statement of Chester Morrill, Assistant Chief of Bureau Markets, Department of Agriculture) (emphasis added).
88. *Id.* at 10 (emphasis added).

bly apply to all futures transactions if the Wallace Amendment were eliminated. The tax, he argued, would apply even to those transactions consummated in off-exchange bucket shops, unless the transactions were subject to the Owners/Growers exemption or unless they were executed by a member of a designated contract market. He believed that commercial transfers of actual grain would not be taxed when executed off-exchange.[89]

Another witness stated that the original bill "was simply [intended] to affect the future transactions and not to interfere with the cash grain" and that the Owners/Growers exemption freed all cash transactions, including those for future delivery, from the tax.[90] He argued that the Wallace Amendment resulted from a misinterpretation of the Owners/Growers exception and urged the removal of the amendment. He thought that the Wallace Amendment invited con artists to make markets in tax-free off-exchange futures. Nevertheless, in order to avoid the application of the tax to cash or spot grain transactions, he suggested adding the following clause: "[t]he words 'future delivery' shall not be held to include any sales of cash grain for deferred shipment."[91]

Thus, under this proposal all contracts for the sale of grain for future delivery would be taxed, but future delivery did not include cash sales for deferred shipment. "Cash grain" meant actual grain, emphasizing the merchandising nature of the exempt transactions.[92] In this way off-exchange bucket shops were outlawed and forward merchandising sales were exempted from the tax. Numerous other witnesses voiced their approval of these proposed changes.[93] Even Mr. Wallace reluctantly agreed that the changes might strengthen the bill.[94]

The Committee adopted the suggested changes by deleting the Wallace Amendment and adding a provision which stated that "the term 'future delivery', as used herein, shall not include any sale of cash grain for deferred shipment" (the "forward contract exclusion").[95] The Senate report stated that the Wallace Amendment was

> added by the House, it is understood, so that any grower or dealer who might sell grain for deferred shipment would not be liable to the payment of the tax . . . . However, with the addition of the [forward contract exclusion] this condition would

89. *Id.* at 193 (statement of F.M. Crosby, Director, Washburn-Crosby Co.).

90. *Id.* at 213-14 (statement of George T. McDermott, Kansas Grain Dealers Association).

91. *Id.* at 214.

92. *Id.* at 463. Senator Capper explained that the House inserted the Wallace Amendment "on the assumption that unless those words were in, it would interfere with a man *selling his own grain*. . . . If you want to be entirely sure that this bill does not effect such transactions, the [forward contract exclusion] . . . will clear up that doubt." *Id.* at 462 (emphasis added).

93. *Id.* at 270, 294, 354-55, 402-03, 431.

94. *Id.* at 462.

95. S. REP. No. 212, 67th Cong., 1st Sess. 1 (1921).

> not obtain. It is obvious also that if [the Wallace Amendment remains] in the bill operations of private exchanges or bucket shops would be possible.[96]

The forward contract exclusion was added "in order that transactions in cash grain when made for deferred shipment or delivery would not fall within the [taxing] provisions."[97] Senator Capper, sponsor of the Senate version of the bill, explained to his colleagues that

> the bill does not concern itself at all with the sale or purchase of *actual grain, either for present or future delivery.* The entire business of buying and selling the *actual grain,* sometimes called 'cash' or 'spot' business, is expressly excluded. It deals only with the 'future' or 'pit' transaction *in which the transfer of actual grain is not contemplated.*[98]

In conference, the House removed the Wallace Amendment. It also agreed to the addition of the forward contract exclusion.[99]

After the Supreme Court struck down parts of the FTA as unconstitutional, Congress quickly went to work to correct the cited defects. No substantive changes were made in the proposed coverage of the GFA.[100] The Owners/Growers exemption was adopted verbatim.[101] The GFA also kept intact the language of the forward contract exclusion, "confirming the notion that a cash forward contract is one in which the parties contemplated physical transfer of the actual commodity."[102]

Legislation to amend the GFA by eliminating the Owners/Growers exemption appeared in 1934 with H.R. 9623.[103] The bill was reintroduced in 1936 as H.R. 6772 in essentially the same form.[104] The amendment was

> intended to clarify section 4 of the [GFA] by striking therefrom an unnecessary exception. Section 4 of that act makes it unlawful to contract for grain for future delivery on or subject to the rules of any board of trade unless such board of trade has been designated as a contract market and such contract is evidenced by a record in writing. The [Owners/Growers] exception . . . which is stricken by the bill purports to except contracts where the seller is "the owner of the actual physical property covered thereby, or is the grower thereof, or in case either party to the contract is the owner or renter of land on which the same is to be grown," etc. The exception is confusing and is uunecessary for two reasons: (1) Section 4 of the act is

96. *Id.*

97. *Id.*

98. 61 CONG. REC. 4762 (1921) (remarks of Sen. Capper) (emphasis added).

99. The House altered the exclusion by adding the words "or delivery" after "shipment." H.R. CONF. REP. No. 362, 67th Cong., 1st Sess. 7 (1921).

100. *Grain Futures Act: Hearings Before the House Comm. on Agriculture*, 67th Cong., 2d Sess. 16 (1922).

101. *Compare* Grain Futures Act of 1922, Pub. L. No. 67-331, § 4, 42 Stat. 998, 999-1000 *with* Futures Trading Act of 1921, Pub. L. No. 67-66, § 4, 42 Stat. 187.

102. NRT Metals, Inc. v. Manhattan Metals Ltd., [1982-1984 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 21,931, at 28,018 (S.D.N.Y. Dec. 7, 1983); *see also* Commodity Futures Trading Comm'n v. Co Petro Mktg. Group, Inc., 680 F.2d 573, 578 (9th Cir. 1982).

103. H.R. 9623, 73d Cong., 2d Sess. § 4 (1934).

104. H.R. 6772, 74th Cong., 1st Sess. § 4 (1936).

limited expressly to contracts for the sale of grain "for future delivery on or subject to the rules of any board of trade in the United States," and (2) the term "future delivery" is defined in section 2 of tbe act so as "not to include any cash grain for deferred shipment or delivery."[105]

The bill was enacted as the CEA, and thereafter only sales of cash grain for deferred shipment or delivery were excused from the exchange-trading requirement.[106] In general,

> Congress reaffirmed and refined the essential statutory distinction it had first made in 1921 between those kinds of contracts for future delivery that it intended either to prohibit or regulate—contracts offered by persons conducting a business in contracts for the future delivery of commodities—and those contracts that it did not intend to regulate or prohibit—cash sale contracts *contemplating actual, although deferred, delivery.*[107]

The CFTC also has interpreted the forward contract exclusion narrowly, concluding that the "exclusion was intended to cover only contracts for sale which are entered into with the expectation that delivery of the actual commodity will eventually occur through performance on the contracts."[108] Forward contracts entail "not only the legal obligation to perform, but also the generally fulfilled expectation that the contract will lead to the exchange of commodities for money."[109] More recently, the CFTC has recognized that forward contracts are "commercial, merchandising transactions in physical commodities in which delivery actually occurs but is delayed or deferred for commercial purposes."[110]

---

105. H.R. REP. No. 421, 74th Cong., 1st Sess. 4-5 (1935).

106. Commodity Exchange Act of 1936, Pub. L. No. 74-675, § 4, 49 Stat. 1491, 1492 (codified as amended at 7 U.S.C. § 6 (1982)).

107. Regulation of Leverage Transactions as Contracts for Future Delivery or Otherwise, [1977-1980 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 20,772, at 23,169 (C.F.T.C., Mar. 12, 1978) (Exhibit I) (emphasis added). The exhibit attached to the leverage memorandum also concludes that "[t]he only category of off-excbange future-delivery contracts that are permitted is the class of commercially motivated cash commodity sales, which contemplate actual delivery of the commodity, but in which delivery may be deferred for purposes of commercial convenience or necessity." *Id.* at 23,164; *see also* 1 T. RUSSO, REGULATION OF THE COMMODITIES FUTURES AND OPTIONS MARKETS 9-13 (1983); Gerstell, *supra* note 3, at 3.

108. *In re* Stovall, [1977-1980 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 20,941, at 23,777 (C.F.T.C., Dec. 6, 1979).

109. *Id.* at 23,778; *see also In re* First Nat'l Monetary Corp., [1984-1986 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 22,698, at 30,976 (C.F.T.C., Aug. 7, 1985) (stating that futures contracts provide "participants with an opportunity to assume or shift the risk of price changes in an underlying commodity without the forced burden of delivery"), *rev'g* [1982-1984 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 21,707, at 26,779-80 (C.F.T.C., Apr. 29, 1983) (stating that "[t]he legislative history indicates that the exclusion for deferred delivery contracts is a very narrow one, intended to meet a particular need, such as that of a farmer to sell part of next season's harvest at a set price to a grain elevator or miller. . . . Consonant with the narrowness of this exclusion is Congress' intention that this exclusion not apply to contracts entered into for speculative purposes").

110. *Regulation of Hybrid and Related Instruments*, 2 Comm. Fut. L. Rep. (CCH) ¶ 23,995, at 34,492 (C.F.T.C., Dec. 11, 1987). The Office of the General Counsel to the CFTC (OGC) bas noted tbat "because forward contracts are commercial, merchandising transactions which result in

The Ninth Circuit has critically examined the underlying purposes of challenged transactions in holding that the exclusion "is unavailable to contracts of sale for commodities which are sold merely for speculative purposes and which are not predicated upon the expectation that delivery of the actual commodity by the seller to the original contracting buyer will occur in the future."[111] Other courts have reached the same conclusion.[112]

In summary, neither the CFTC nor the courts have had difficulty applying the "intent to deliver" criterion for distinguishing between futures and forwards. Legislative history demonstrates a congressional intent to regulate futures contracts. Congress intended to excuse from the otherwise plenary reach of the exchange-trading requirement only a very narrow class of future-settling contracts that contemplate the transfer of actual ownership of a commodity in a commercial, merchandising transaction. Congress apparently concluded that cash deferred contracts, which contemplate the transfer of actual ownership of a commodity, could not be used to manipulate prices. Conversely, future-settling contracts that did not contemplate actual delivery, regardless of the nature of the parties involved, posed a sufficient threat to require that they be traded only on monitored exchanges.

V. THE TREASURY AMENDMENT

Congress added the so-called Treasury Amendment to the CEA in 1974 as part of a major revision of federal commodities regulation. The amendment states that the CEA shall not apply "to transactions in" foreign currencies, government securities and other enumerated financial instruments "unless such transactions involve the sale [of such in-

---

delivery, . . . the Commission [looks] for evidence of the transactions' use in commerce." *Characteristics Distinguishing Cash and Forward Contracts and "Trade" Options*, [1984-1986 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 22,718, at 31,026-27 (C.F.T.C., Sept. 30, 1985). The CFTC views "expectation of delivery" as a legal element in actions it brings alleging violations of CEA § 4(a). *Cf.* Commodity Futures Trading Comm'n v. James Timpson & Assoc., No. 86-1342T (S.D. Cal. June 18, 1986) (paragraph 19 of complaint alleging violations of CEA § 4(a)) (stating that "[b]y these and similar representations, customers who purchased . . . contracts did not have the expectation that they would be required to take delivery of the metals which are the subjects of the contracts").

111. Commodity Futures Trading Comm'n v. Co Petro Mktg. Group, Inc., 680 F.2d 573, 579 (9th Cir. 1982).

112. *See* Commodity Futures Trading Comm'n v. Co Petro Mktg. Group, Inc., [1980-1982 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 21,086, at 24,380 (C.D. Cal. May 8, 1980) (stating that "[t]he exclusion was intended to apply only to those contracts for sale which are predicated upon the expectation that delivery of the *actual* commodity by the seller will in fact occur"); NRT Metals, Inc. v. Manhattan Metals Ltd., [1982-1984 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 21,931, at 28,018 (S.D.N.Y. Dec. 7, 1983) (stating that "[t]he exemption clearly encompassed only those contracts which promised the actual delivery of grain at a specified time in the future").

struments] for future delivery conducted on a board of trade."[113]

The 1974 legislation originally did not include the Treasury Amendment. There was concern, however, that the new and expanded definition of "commodity" would encompass interbank forward market trading in foreign currencies, and therefore subject such transactions to terms of the CEA. During the Senate hearings, the representative of a major bank complained that a number of the proposed provisions "appear particularly troublesome and burdensome if they are construed as applying to foreign exchange transactions of the kind executed in the interbank market."[114] He described the market as "designed to service customers of the bank who have a commercial need to buy and sell foreign exchange."[115] The concerns expressed by the witness are misplaced because the described transactions have many of the characteristics of instruments already beyond the reach of the CEA such as cash trades or commercial merchandising forward trades. Even today, the overwhelming majority of all interbank transactions are in cash (with forwards comprising a smaller percentage of transactions).[116]

Nevertheless, after the hearings (but before final mark-up began) the Treasury Department sent the chairman of the Senate Agriculture and Forestry Committee a letter reiterating many of the concerns previously expressed by the major bank. The letter noted that the proposed expansion of the definition of "commodity" would include foreign currencies and that "futures" trading in foreign currencies would therefore be subject to regulation under the CEA.[117] The letter also stated that the proposed legislation did not "clearly indicate that the new regula-

---

113. 7 U.S.C. § 2 (1982).

114. *Commodity Futures Trading Commission Act: Hearings Before the Senate Comm. on Agriculture and Forestry*, 93d Cong., 2d Sess. 772 (1974).

115. *Id.* at 771. The Comptroller of the Currency later described the interbank market of the period as involving cash and forward contracts. He failed to mention the presence of any futures trading. *See also infra* notes 148-50 and accompanying text (discussing April 11, 1986 letter from the Comptroller of the Currency to the C.F.T.C.).

116. *See, e.g.*, COMMITTEE ON FUTURES REGULATION OF THE ASSOCIATION OF THE BAR OF THE CITY OF NEW YORK, THE EVOLVING REGULATORY FRAMEWORK FOR FOREIGN CURRENCY TRADING 4 (Working Paper 1987); FEDERAL RESERVE BANK OF NEW YORK, SUMMARY OF RESULTS OF U.S. FOREIGN EXCHANGE MARKET TURNOVER SURVEY CONDUCTED IN MARCH 1986 (Aug. 20, 1986); Andrews, *Recent Trends in the U.S. Foreign Exchange Market*, 9 FED. RESERVE BOARD N.Y. Q. REV. 38 (1984); Revey, *Evolution and Growth of the United States Foreign Exchange Market*, 6 FED. RESERVE BOARD N.Y. Q. REV. 32 (1981).

117. S. REP. No. 1131, 93d Cong., 2d Sess. 49-50 (1974). The Treasury Department seemingly was groping for the same accommodation between regulation of "futures" and nonregulation of "forwards" that caused Secretary of Agriculture Wallace to propose his amendment in 1921. Like Secretary Wallace, the Treasury Department may have intended to use the word "futures" broadly to mean executory contracts for the purchase or sale of commodities, regardless of whether the contracts were true futures or commercial merchandising transactions for cash but deferred delivery.

tory agency's authority would be limited to the regulation of futures trading on organized exchanges, and would not extend to futures trading in foreign currencies off organized exchanges."[118]

Regulation of "foreign currency futures trading of banks or other institutions, other than on an organized exchange" was deemed unnecessary and ill-advised for several reasons. First, the Treasury Department, while acknowledging that "other institutions" sometimes traded currency "futures," explained that virtually all such trading took place through an informal network of banks and dealers who were sophisticated and informed, unlike many of the public participants in designated contract markets.[119] Second, the Treasury Department indicated that the Comptroller of the Currency and the Federal Reserve already were "taking action to achieve closer supervision of the trading risks involved in [futures trading]."[120] Finally, Treasury feared that limiting futures trading in currencies to exchanges "could have an adverse impact on the usefulness and efficiency of foreign exchange markets."[121] It concluded that regulation of transactions in security warrants, security rights, resales of installment loan contracts, repurchase options, government securities, mortgages and mortgage purchase commitments, or in puts and calls for securities, "which generally are between large, sophisticated institutional participants, is unnecessary, and could be harmful."[122]

The Senate Committee adopted the Treasury Amendment, using the language recommended by the Treasury Department.[123] The amendment as adopted, however, did not include puts and calls on securities among the list of excluded financial instruments.[124] In its explanation of the amendment, the Senate Report "clarified" that "interbank trading of foreign currencies and specified financial instruments is not subject to Commission regulation."[125] The report later stated that "[a] great deal of the trading in foreign currency in the United States is carried out through an informal network of banks and tellers" that "is more properly supervised by the bank regulatory agencies."[126] The Committee found it unnecessary to regulate the other financial instruments enumerated in the amendment because these instruments "generally are between banks and other sophisticated insti-

118. *Id.* at 49.
119. *Id.* at 50.
120. *Id.*
121. *Id.*
122. *Id.* at 51.
123. *Id.* at 54-55.
124. *Id.*
125. *Id.* at 6.
126. *Id.* at 23.

tutional participants."[127] In contrast to the Treasury Department's repeated references to interbank "futures" trading, the Committee refrained pointedly from describing transactions affected by the amendment as "futures."[128] The Conference Committee later accepted the Senate's amendment, similarly refraining from any references to "futures."[129]

For numerous reasons the scope of the Treasury Amendment should be limited to forward contracts. The plain language of the amendment indicates that only cash and forward trading are excluded from the exchange-trading requirement.[130] By its terms, the amendment applies only to "transactions in" the listed commodities, unless the transactions "involve the sale [of such commodities] for future delivery."[131] Futures (and options) trading, however, takes place, not *in* commodities, but in executory contract rights to purchase and sell cash commodities at a later date. Such trading consists of

> formation of contracts for later sale of a commodity. No commodity is sold when a futures contract is formed; futures transactions are transactions in *rights* to the commodity rather than in the commodity itself. . . . [T]he futures contract market may be viewed as a forum for dealing in contracts to make a contract, or contracts to make a later sale.[132]

Thus, a futures (or option) contract is not a transaction *in* a commodity, but at most is a transaction *involving* commodities (*i.e.*, carrying the potential for their later purchase or sale).[133] Numerous decisions

---

127. *Id.*

128. Compare the Department of Treasury's description of an "ambiguity" in the bill, namely that its provisions "do not clearly indicate that the new regulatory agency's authority would be limited to the regulation of futures trading on organized exchanges, and would not extend to *futures trading* in foreign currencies off organized exchanges," *id.* at 49 (emphasis added), with the Committee's statement that the "amendment provides that inter-bank trading [*and not futures trading*] of foreign currencies . . . is not subject to Commission regulation." *Id.* at 6.

129. H.R. CONF. REP. No. 1383, 93d Cong., 2d Sess. 35 (1974).

130. 7 U.S.C. § 2 (1982) (stating that "[n]othing in this Chapter shall be deemed to govern or in any way be applicable to *transactions in* [certain financial instruments]" (emphasis added)).

131. *Id.*

132. Clark, *Geneology and Genetics of "Contract of Sale of a Commodity for Future Delivery" in the Commodity Exchange Act*, 27 EMORY L.J. 1175, 1175-76 (1978) (emphasis in original, footnotes omitted).

133. Evidence of congressional sensitivity to the notion that futures contracts *involve* commodities can be found in § 3 of the CEA (originally enacted as part of the GFA in 1922). That provision, which discusses the need for regulation of futures markets, begins with a finding that "[t]ransactions in commodities *involving the sale thereof* for future delivery as commonly conducted on boards of trade and known as 'futures' are affected with a national public interest." 7 U.S.C. § 5 (1982) (emphasis added).

Further evidence is found in the FTA, which imposed a prohibitive tax on each bushel of grain "involved" in options transactions and "involved" in sales for future delivery (unless executed on a contract market). The following exchange on the floor of the House demonstrates that Congress carefully considered the meaning of the word "involved" when it drafted the FTA:

Mr. Cooper: I notice . . . there is levied a tax of 20 cents a bushel on every bushel involved in have recognized this distinction.[134]

The wording of the amendment's "escape" provision—that the CEA shall not apply to transactions in the enumerated financial instruments "*unless such transactions involve the sale thereof for future delivery conducted on a board of trade*"[135]—lends further support that the Amendment does not reach futures trading because futures contracts are not "transactions in" commodities. The purpose of the escape provision

> is not to except . . . futures from the Treasury Amendment. Rather, the "unless" clause is needed (and was enacted) to except the transactions in security rights, etc. that occur when a futures contract is actually performed . . . . *The futures . . . contract is not a transaction in a commodity* but insofar as it may *presage some future transfer of the commodity,* the latter is excepted from the Treasury Amendment by the "unless" clause.[136]

In other words, the escape provision was adopted to insure that the Treasury Amendment did not apply and that CFTC jurisdiction did extend to cash market transactions—*i.e.*, to "transactions in" the financial instruments—necessary to consummate actual delivery on exchange-trade futures contracts.

[futures] transactions. There is no "bushel" involved.

Mr. Purnell: Only mathematically.

Mr. Cooper: There is no bushel of grain involved. Suppose they would say technically that there was no grain involved in it?

Mr. Purnell: Certainly the intent of the law is to tax every bushel of grain that is involved, either actually or theoretically. In other words, if a man buys in a speculative way, with no intention of having it delivered, 50,000,000 bushels or 1 bushel, he must pay the tax.

61 CONG. REC. 1320 (1921) (remarks of Reps. Cooper and Purnell).

More recently, Congress enacted a bill regulating the cash market for government securities (instruments included within the reach of the Treasury Amendment). The act contained conforming amendments that, among other things, added definitions to § 3(a) of the Securities Exchange Act of 1934. The new definitions for "government securities broker" and "government securities dealer" exclude certain persons and entities that "effect[] *transactions in* government securities." Government Securities Act of 1985, Pub. L. No. 99-571, § 102(d), 100 Stat. 3208, 3217 (1986) (emphasis added) (codified at 15 U.S.C. § 78c(a)(43)(44) (Supp. IV 1986). The language is consistent with congressional awareness that cash transaction are *in* commodities.

Read together, these statutes demonstrate that Congress long ago discovered that futures (and option) transactions *involve* commodities and that cash and forward transactions are *in* commodities.

134. *See* Commodity Futures Trading Comm'n v. American Bd. of Trade, 803 F.2d 1242, 1248-49 (2d Cir. 1986); Board of Trade of Chicago v. SEC, 677 F.2d 1137, 1154 (7th Cir. 1982); Commodity Futures Trading Comm'n v. American Bd. of Trade, 473 F. Supp. 1177, 1182-84 (S.D.N.Y. 1979); Commodity Futures Trading Comm'n v. Sterling Capital Co., [1980-1982 Transfer Binder] Comm. Fut. L. Rep. ¶ 21,169, at 24,783-84 (N.D. Ga. Feb. 20, 1981). The Commodity Futures Trading Commission as well has adopted the position that options transactions "involve," but are not transactions "in," commodities. *See* Brief for Plaintiff-Appellee C.F.T.C. at 26-28, Commodity Futures Trading Comm'n v. American Bd. of Trade (Nos. 81-6240, 85-6134, and 85-6388).

135. 7 U.S.C. § 2 (1982) (emphasis added).

136. *Board of Trade of Chicago*, 677 F.2d at 1154 n.33 (emphasis added).

Moreover, Congress noted expressly that the amendment merely "clarified" existing law. Such a characterization makes sense if the amendment makes clear that cash and forward transactions in the enumerated financial instruments are not regulated under the CEA, a result implicit in the forward contract exclusion. Clarification, however, hardly would be an appropriate description of congressional action intended to deviate from the CEA's longstanding policy of restricting the trading of commodities for future delivery to designated exchanges. The absence of any reference in the amendment's legislative history to *futures* transactions further indicates a congressional intent to restrict the provision's application to cash and forward transactions.

A broad reading of the amendment permits bucket shops as well as banks to trade futures outside the CEA. This result contravenes a central feature of the 1974 amendments—bringing all previously unregulated futures within the CEA's umbrella—and is particularly unreasonable, since Congress in 1974 was trying to stamp out rampant abuses in the off-exchange sale of naked options.

The Treasury Amendment has been interpreted consistently as removing only cash and forward transactions in the enumerated financial instruments from the jurisdiction of the CFTC.[137] CFTC staff first considered the amendment in a published letter to the SEC chairman, stating that the amendment

> was intended to make clear that the CFTC would not have any jurisdiction with respect to the purchase and sale of the enumerated financial instruments themselves (the "cash market"), but would have jurisdiction solely with respect to futures trading in those instruments. Absent such a provision, various sections of the [CEA] would have given the CFTC jurisdiction over cash market manipulation of financial instruments for which a futures contract market had been designated.[138]

Two years later, the OGC interpreted the amendment

> as an expression that regulation by the Commission is unnecessary where there exists an informal market among institutional participants in transactions for future delivery in the specified financial instruments only so long as it is supervised by those agencies having regulatory responsibility over those participants. However, where that market is not supervised and where those transactions are conducted with participation by members of the general public, we do not understand the Committee to have intended that a regulatory gap should exist. In these circumstances, we believe the Commodity Exchange Act should be construed broadly to assure that the public interest will be protected by Commission regulation of those transactions.[139]

---

137. *Cf.* Abrams v. Oppenheimer Gov't Sec., Inc. 737 F.2d 582, 590 (7th Cir. 1984) (stating that "[t]he legislative history behind the 1974 amendment indicates the Treasury Department was concerned that the CFTC might exceed its jurisdiction in regulating financial instruments such as GNMA *forwards* which are not traded on an organized exchange" (emphasis added)).

138. *SEC-CFTC Jurisdictional Correspondence*, [1975-1977 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 20,117, at 20,834 (C.F.T.C. Staff Response, Dec. 3, 1975).

139. *CFTC Interpretative Letter No. 77-12 (Dealers in GNMA Certificates as Board of*

Reference to market supervision by regulatory agencies other than the CFTC did not create an exception to the exchange-trading requirement; rather, it was intended to justify the limiting of cash and forward market jurisdiction in the enumerated markets that were regulated by other agencies.

The CFTC most recently considered the Treasury Amendment in a 1985 statutory interpretation and request for comments. It explained that the amendment "excludes from the Commission's exclusive jurisdiction over futures contracts certain off-exchange transactions in foreign currencies and other enumerated financial instruments" and "applies only when such transactions are entered into by and between banks and certain other sophisticated and informed institutional participants."[140] The marketing of futures transactions in foreigu currencies "to the general public . . . is strictly outside the scope of the Amendment."[141] The 1985 statutory interpretation concluded with a request for comments and information.[142]

The CFTC received many responses to its request for comments, including letters from the Federal Reserve, the Comptroller of the Currency, and the Treasury Department. The Federal Reserve prefaced its comments by stating that it understood "the CFTC does not . . . intend to interfere with legitimate transactions by banks and other regulated dealers, recognizing that at a minimum such transactions are excluded from the CFTC's jurisdiction by the . . . Treasury Amendment."[143] This prefatory statement is correct to the extent that "legitimate transactions" are meant to include cash and forward transactions.

The Federal Reserve went on to note that the off-exchange market "has contributed to the liquidity, resiliency, and efficiency of the exchange market."[144] It also recommended that the interbank market re-

---

Trade), [1977-1980 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 20,467, at 21,912 (O.G.C. Aug. 17, 1977).

140. 50 Fed. Reg. 42,984 (Oct. 23, 1985).

141. *Id.* at 42,985.

142. *Id.* Recent amendments to the CEA that ban leverage contracts in foreign currencies—contracts closely resembling futures contracts—tend to confirm the CFTC's opinion that Congress has not authorized the sale of foreign currency futures to the public. *See* Futures Trading Act of 1986, Pub. L. No. 99-641, § 109, 100 Stat. 3556, 3560 (codified at 7 U.S.C. § 23 (Supp. IV 1986)).

143. Letter from the Federal Reserve Board to the CFTC (Mar. 5, 1986).

144. *Id.* No doubt some off-exchange trades later result in a party covering itself through exchange trades. But to justify off-exchange trading of futures by pointing to secondary use of organized futures markets misses the point. Congress determined as a policy matter that the advantages of centralized exchange trading of futures contracts outweighed disadvantages of limiting trading in over-the-counter futures. It is disingenuous to argue that illegal off-exchange markets should be condoned because they produce marginal benefits for legal markets because even compelling policy arguments cannot of themselves repeal a statute. Presumably policy was considered and a balance struck when the forward contract exclusion and the Treasury Amendment were

main open to otherwise unsuitable participants (*i.e.*, members of the public) whenever designated exchanges could not provide these participants with the amount or type of currency needed for commercial or investment purposes, and when the participants or the transactions met other exemptive criteria (generally related to the size of the transactions and the sophistication of the participants).[145]

This unacceptable approach completely ignores the exchange-trading requirement. The CEA focuses on the nature of the transaction, requiring that all contracts for the purchase or sale of commodities for future delivery be executed on designated exchanges; it supplies no exemption or special solicitude for size or sophistication or the absence of exchange-traded alternatives. Indeed, given the public harm caused by the various failures of large and sophisticated, but unregulated, government securities traders, arguably the risk to the public from unfettered trading increases with size. Allowing exceptions to the exchange-trading requirement erodes the advantages of exchange trading and materially heightens the danger of manipulation and disruptive bankruptcies. These dangers could have potentially disastrous and far reaching consequences for innocent third parties.

Admittedly, these risks diminish to the extent other federal agencies monitor interbank *futures* trading. But currently no federal agencies monitor this trading. Non-CFTC regulators place no substantive restrictions on the volume, type, or structure of interbank transactions. Nor do these regulators promulgate regulations that specifically address the dangers associated with futures trading. Interbank transactions need not be reported, which apparently accounts for the lack of any reliable estimates on even the size of the market. Banks have absolute discretion over whether, and with whom, they choose to do business. Credit concerns are private contractual matters left to the parties. Prices of consummated transactions are not reported. While regulators scrutinize bank records to insure compliance with various substantive restrictions (such as general capital requirements), they monitor "futures" trading only incidentally. Banks that trade foreign currency may be regulated, but their regulators do not enforce the CEA, CFTC regulations, or exchange rules, nor do the regulators act to promote the goals underlying the CEA.[146] Moreover, a significant amount of cur-

---

drafted. While critics can disagree with that balance, it is for Congress alone to alter. Further, it is unclear as an empirical matter the extent to which off-exchange transactions benefit exchange trading.

145. *Id.*

146. The Fed began distributing a monthly FOREX survey to major banks in the 1970s. The survey requests general information about the size and types of transactions entered the previous month, and is used to gauge overall market size and the relative activity in different instrument

rency trading is conducted by nonbank brokers who operate without substantive regulatory oversight.[147]

The Comptroller of the Currency also responded to the CFTC's request for information and described the foreign exchange market of the mid-1970s. The Comptroller explained that commercial banks entered transactions "for their own account and for the accounts of customers who had legitimate business needs to buy or sell foreign currencies *for forward settlement*."[148] A few of the customers were individuals "financing their business affairs through the bank executing the *forward [foreign exchange] transactions*."[149] These comments confirm that the concern in 1974 was that the CFTC would exercise jurisdiction over interbank cash and forward transactions. The Comptroller also indicated that he had received no consumer complaints within the past two years regarding foreign exchange transactions with national banks, which implied that the concerns of rampant fraud were unfounded.[150]

The Treasury Department sent the last—and most surprising—letter.[151] It began by expressing the concern that any interpretation of the Treasury Amendment which permitted the CFTC to exercise jurisdiction over the interbank market would logically apply to the market for government securities as well—instruments included in the amendment and an area over which Treasury was seeking exclusive jurisdiction.[152] It concluded by recommending modification of the Treasury Amendment to create CFTC jurisdiction over public interbank currency trading provided that such an amendment would not impair "legitimate hedging transactions."[153] Treasury apparently misread the amendment to remove any kind of trading—including futures trading—from the reach of the CEA, instead of reading the plain language of the amendment to apply only to "transactions in" the listed financial

---

types and currencies. It also solicits a limited amount of information about the nature of the counterparties. Compliance is voluntary. The Fed also has a Foreign Exchange Committee that issues an annual report. The report contains various recommendations on how to deal with recurring industry problems. While these recommendations are generally followed, compliance is voluntary. Last, the 1980 Guidelines issued by the Federal Financial Institutions Examination Council recite prudent accounting standards but have a force and effect no greater than the annual report. Failure of the CFTC to exercise its jurisdiction over futures trading in the interbank market would create the kind of regulatory gap Congress hoped to prevent.

147. *See* R. KUBARYCH, FOREIGN EXCHANGE MARKETS IN THE UNITED STATES 13-15 (1983).

148. Letter from the Comptroller of the Currency to the CFTC (Apr. 11, 1986) (emphasis added).

149. *Id.* (emphasis added).

150. *Id.*

151. Letter from the Department of Treasury to the CFTC (May 5, 1986).

152. *Id.* Congress recently passed a bill giving tbe Treasury rule making authority over the market in government securities. Government Securities Act of 1985, Pub. L. No. 99-571, 100 Stat. 3208 (1986) (codified at scattered sections of 15 U.S.C. (Supp. IV 1986)).

153. Letter from the Department of Treasury to CFTC (May 5, 1986).

instruments (*i.e.*, cash and forward transactions).

As a result of these and other submissions, the CFTC has deferred issuance of a definitive interpretation of the Treasury Amendment.[154] But its silence should not be interpreted as a shift from its longstanding view that the amendment applies only to cash and forward transactions in the enumerated financial instruments. This view is supported by the unequivocal language of the amendment, its legislative history, recent case law vindicating CFTC enforcement actions, and the fundamental structure of futures regulation in the United States which requires that all futures be traded on designated exchanges.

VI. CFTC EXCLUSIVE JURISDICTION

The CEA amendments, which the House passed in 1974, provided that the jurisdiction of the CFTC "shall be exclusive with respect to transactions involving contracts of sale of a commodity for future delivery which are traded or executed on a domestic board of trade or contract market or any other board of trade, exchange or market."[155] The House Report clearly stated that CFTC jurisdiction extended to "all futures transactions and all cash transactions related thereto."[156] This jurisdiction extended to such transactions when executed on "not only domestic boards of trade but also 'on any other board of trade, exchange, or market,' "[157] indicating that the CFTC would have exclusive jurisdiction over futures executed on foreign exchanges as well as those illegally executed off-exchange.

The Senate Committee on Agriculture and Forestry added language stating that the CFTC's exclusive jurisdiction "includes the regulation of commodity accounts, commodity trading agreements, and commodity options."[158] The Committee also limited the CFTC's jurisdiction to futures contracts "traded or executed on a contract market designated pursuant to section 5 of this Act," eliminating the words "or any other board of trade, exchange, or market."[159] This change apparently was intended as an expression of Senate disapproval of exclusive CFTC jurisdiction over transactions on foreign exchanges.[160] The Senate passed the bill following the addition of a clause which stated that

154. Gerstell, *supra* note 3, at 6.

155. H.R. 13113, 93d Cong., 2d Sess., as passed by the House and referred to the Senate Agriculture and Forestry Committee (Apr. 22, 1974).

156. H. REP. No. 975, 93d Cong., 2d Sess. 7-8 (1974); *see also* 7 U.S.C. § 13 (1982).

157. H. REP. No. 975, 93d Cong., 2d Sess. at 8.

158. S. REP. No. 1131, 93d Cong., 2d Sess. 6 (1974).

159. H.R. 13113, 93d Cong., 2d Sess., as reported by the Senate Agriculture and Forestry Committee (Aug. 29, 1974).

160. S. REP. No. 1131, 93d Cong., 2d Sess. 31 (1974) (stating that the CFTC will have exclusive jurisdiction "over all futures transactions which are executed on domestic boards of trade").

the CFTC had exclusive jurisdiction over leverage contracts.[161]

The conference committee accepted the "clarifying" Senate changes, although it also restored the extension of jurisdiction proposed by the House. Therefore, jurisdiction was extended to futures instruments bought and sold in the United States (but executed on a foreign exchange) by reinserting the phrase "on any other board of trade, exchange, or market."[162] Congress further amended the CEA in 1982 to resolve a jurisdictional dispute between the CFTC and SEC, but nothing in the legislative history of that or any subsequent amendment indicates an intent to limit CFTC jurisdiction over futures contracts.[163]

VII. The Safe Harbor Proposal

The CFTC, in an advance notice of proposed rulemaking, has suggested the creation of a "safe harbor" from its supervisory jurisdiction for certain commercial transactions.[164] The advance notice advocates the creation of a no-action procedure for executory transactions that do not result in physical delivery of a commodity, provided that the transactions are entered by commercial merchandisers for non-speculative purposes and further provided that the transactions satisfy all of the other requirements of the forward contract exclusion.[165]

In making its proposal, the CFTC recognized that

> [w]hile the infrequency of delivery of the commodity in such transactions would tend to preclude their characterization as forward contracts within the [CEA's] jurisdictional exclusion, such transactions nonetheless appear to be essentially private, commercial transactions that generally involve the exchange of interests in an actual physical commodity. As such, *while beyond the established definition of forward contracts*, such transactions may be suitable for a [CFTC] no-action position to the extent that they occur other than on a designated contract market.[166]

---

161. 120 Cong. Rec. 30,468 (1974).

162. *Cf. id.* 34,737 (remarks of Representative Poage) (stating that "[t]he words 'any other board of trade, exchange or market' were included in the conference substitute only for the purpose of giving the [CFTC] jurisdiction over futures contracts purchased and sold in the United States and executed on a foreign board of trade, exchange or market").

163. The CFTC has rejected the argument that its jurisdiction extends to futures contracts only if they are transacted on or through the facilities of an exchange. Quoting the Administrative Law Judge who first addressed the argument, the CFTC noted that "*the requirement that a futures contract be executed on a designated contract market is what makes the contract legal and not what makes it a futures contract.*" *In re* Stovall, [1977-1980 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 20,941, at 23,779 (C.F.T.C., Dec. 6, 1979) (emphasis in original).

164. *Regulation of Hybrid and Related Instruments*, 2 Comm. Fut. L. Rep. (CCH) ¶ 23,995 (C.F.T.C., Dec. 11, 1987). A committee of the New York Bar had made a similar suggestion previously. *The Forward Contract Exclusion: An Analysis of Off-Exchange Commodity-Based Instruments*, 41 Bus. Law. 853, 855 (1986).

165. *Regulation of Hybrid and Related Instruments*, 2 Comm. Fut. L. Rep. (CCH) ¶ 23,995, at 34,491-34,494 (C.F.T.C., Dec. 11, 1987).

166. *Id.* at 34,492 (emphasis added).

The CFTC proposal would be limited to direct transactions between commercial counterparties (*i.e.*, transactions that occur without the services of dealers, market-makers, or other third parties) entered incident to their routine course of business rather than for speculative or investment purposes.[167] In addition, the instruments involved could not be transferred.[168] The CFTC also suggested a no-action procedure for another class of transactions involving intangible "services, rights and interests" not easily susceptible to physical delivery, such as instruments in which returns are tied to variable-rate indices or to the performance of baskets of commodities.[169]

This approach departs from the CEA's focus on the nature of the transaction rather than the nature of the participant, and finds no support in the language of the CEA, its legislative history, or court and CFTC interpretations.[170] Furthermore, it threatens to remove from CFTC supervision transactions likely to cause public harm.[171] Congress determined that unbridled speculation fostered manipulation that was detrimental to the public's interest. To better manage this threat, Congress confined all transactions involving the purchase or sale of commodities for future delivery to licensed exchanges. Congress excluded commercial merchandising transactions that contemplate delivery of actual commodities ("forward contracts") from its definition of "future delivery." Apparently, the theory underlying this definition was that such transactions do not raise the specter of manipulation. While all such forward contracts are (by definition) commercial in nature, not all transactions by commercial parties are forwards. This is largely because not all transactions by commercial parties contemplate delivery.

The CFTC's position is objectionable for many reasons. The most compelling reason is that this position implies that the CFTC can ignore its congressional grant of jurisdiction and concomitant obligation to prohibit off-exchange futures whenever, in its opinion, the advantages of off-exchange futures trading outweigh its disadvantages. The CEA simply does not give the CFTC such discretion.[172] Further, the

167. *Id.* at 34,493.

168. *Id.*

169. *Id.* at 34,493-34,494.

170. Congress recognized the need to regulate futures markets after concluding that *both the public and commercial parties* participate in futures markets. 7 U.S.C. § 5 (1982) (stating that "[f]utures transactions are carried on in large volume by the public generally and by persons engaged in the business of buying and selling commodities and the products and byproducts thereof in interstate commerce").

171. *See* Architzel & Tosini, *supra* note 59, at 3 (warning that the benefits of off-exchange trading between commercial entities come at a cost).

172. *See* 132 CONG. REC. S13587 (daily ed. Sept. 25, 1986) (remarks of Sen. Lugar) (stating that "[u]ltimately, the decision whether to alter the statute [to accommodate off-exchange instruments] rests with Congress, and only with Congress").

CFTC's narrow focus on commercial participation is misplaced. The mere absence of public participation does not insulate a transaction from the CEA or its exchange-trading requirement. Commercial parties often speculate, as well as hedge, and therefore the dangers of manipulation remain. While the CFTC is on target with its attempts to limit the availability of the no-action procedure to non-speculative transactions, it creates no mechanism to monitor compliance. The temptation for commercial parties to offset positions as market expectations change over time may be too tempting to resist, even when transactions are entered originally for legitimate commercial reasons.[173] The CEA creates no exceptions for size or sophistication, recognizing that anyone—including commercials—can speculate excessively.[174] The wisdom of this broad approach has been demonstrated by the recent failures of several unregulated government securities firms, whose off-exchange trading of unregulated financial instruments has led to serious public harm.[175]

---

173. *Cf.* Grant, *Why Treasurers are Swapping Swaps*, EUROMONEY, Apr. 1985, at 19 (discussing bow corporate treasurers are increasingly offsetting profitable swap positions entered originally as hedges).

174. *Cf. House Hearings on Future Trading, supra* note 76, at 7-8.

175. *See supra* notes 60-64 and accompanying text.

The demand for a safe harbor first found sympathetic ears in the OGC of the CTFC, which issued a cryptic no-action letter relating to an export trading company's proposed sale of certain future-settling commodity sales contracts. Seventy-five percent of the anticipated transactions were expected to involve commodities similar or identical to those traded on exchanges. All contracts were expected to settle in cash, and actual delivery could never take place.

OGC predicated its no-action position on the company's representations that the contracts would be marketed to commercial customers and not to the public. It further conditioned its position on the approval of the plan by the Federal Reserve Board—the agency that OGC expected to monitor the company.

OGC did not specify whether it found the proposed instruments beyond the scope of its jurisdiction or whether it was simply declining to exercise jurisdiction. In the opinion of one commentator, OGC's position "has the likely effect of establishing a previously unknown exception from the Act's on-exchange trading requirement for a category of transactions which may be viewed as 'trade futures.'" This alludes to an exception to the options ban for commercial, non-speculative commodity options purchased by persons in the trade. *See generally* Yeres, FIA REV., Sept.-Oct., 1986, at 10-11.

The no-action letter falls short to the extent it characterizes the proposed commodity contracts as forwards. Forwards must be commercial, merchandising transactions contemplating actual delivery. The proposed contracts can never satisfy this condition because tbey settle in cash.

Finally, the CEA does not permit the CFTC to abdicate its responsibility to administer the exchange-trading requirement even if a party to an off-exchange futures transaction is regulated by another federal agency. The extraordinary statutory grant to the CFTC of exclusive jurisdiction over futures mandates that the CFTC not defer to other federal agencies on matters or activities covered by the CEA. *Cf.* 132 CONG. REC. S13586 (daily ed. Sept. 25, 1986) (remarks of Sen. Dixon).

VIII. Conclusion

Forwards and futures evolved as contractual solutions to distinct problems. Forward contracts aided in the distribution of goods, while futures contracts transferred risk from risk-averse producers and merchants to speculators. When Congress first regulated futures trading, its primary concerns were the prevention of price manipulation and the elimination of bucket shops. Congress concluded that price manipulation arose from undue speculation. Futures trading was limited to designated exchanges in order to harness speculation and to better manage perceived abuses in the marketplace. Unregulated private exchanges and bucket shops were prohibited. Although all contracts for the purchase or sale of commodities for future delivery had to be traded on federally designated exchanges, forward contracts were excluded from the definition of future delivery. The distinction in treatment was based both on history and policy. The Treasury Amendment, adopted in 1974, merely clarified the distinctions established in the early 1920s between cash and futures transactions, with respect to certain enumerated financial instruments that became commodities under the 1974 amendments.

The rule Congress articulated is an easy one—only cash transactions and commercial, merchandising contracts contemplating actual delivery are excused from the exchange-trading requirement. This requirement promotes important public policy goals. Unless Congress changes this rule, traders in off-exchange future-settling commodities contracts that do not contemplate delivery run the risk of both civil and criminal penalties for violating section 4(a) of the CEA.