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I. Introduction

In the last few years, "an endless stream of exotic financial instruments conjured by Wall Street wizards" literally has taken the financial community by storm, fundamentally altering market trading practices and pitting institutions against each other in an intense competition for development of still more innovative instruments.[1] These products—which include various types of "swaps," options, forward contracts, and price guarantees—now are being offered to and traded by every major financial institution and multinational corporation in the world, as well as by governments and individuals, and nothing indicates that the unprecedented growth of the markets for such instruments is likely to subside any time soon. To the contrary, the trend clearly is toward increased "product proliferation" and the addition of still more arcane and complex trading vehicles to the already dizzying array now available.

The speed with which these products have reached the markets plainly has outstripped the ability of accountants, lawyers, and regulators to keep pace with their development and to determine their status under prevailing law and practices. In particular, although these products to some extent parallel existing instruments within the traditional regulatory jurisdiction of the Securities and Exchange Commission (SEC) and the Commodity Futures Trading Commission (CFTC), their new and varied features have created substantial uncertainty as to the proper locus of regulatory jurisdiction over their trading. Whether the SEC, CFTC, or other agencies have exclusive or concurrent jurisdiction with respect to these new instruments, or whether they even have jurisdiction at all, often is unclear.

This Article first will discuss the general scope of the commodities and securities industries and the respective regulatory spheres of the CFTC and SEC. This background is essential to any understanding of the nature and regulatory status of new financial instruments, many of which are derived from more traditional types of investment and trading vehicles within the jurisdiction of these agencies, and all of which have been structured to minimize the likelihood of being encompassed within such jurisdiction. Indeed, it is virtually impossible to appreciate the potential regulatory problems associated with the offer and sale of such instruments

1. *New Distortions in Financial Statements*, DUN'S BUS. MONTH, June 1986, at 46.

without at least some detailed knowledge of the regulatory environments from which they developed.

Following this discussion, the Article will focus on the nature of certain new financial instruments and will analyze the applicability of SEC and CFTC jurisdiction to those instruments.[2] Finally, the Article will make recommendations regarding the future course of this regulatory structure.

II. THE COMMODITY FUTURES INDUSTRY

The commodity futures industry comprises a variety of different types of instruments and a number of categories of individuals and entities engaged in a broad range of trading activities. The industry principally involves the trading of futures and option contracts on regulated exchanges, known as "contract markets," subject to the exclusive regulatory jurisdiction of the CFTC under the Commodity Exchange Act (CEA).[3] As discussed below, it also includes a number of off-exchange products.

Exchange traded futures and option contracts are entered into through registered brokerage firms, known as "futures commission merchants" or "FCMs," subject to extensive and intensive CFTC regulation.[4] In particular, FCMs must maintain a specified level of

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2. This Article does not address a wide variety of financial instruments. Several of them have spawned publications that are confined solely to those instruments. Space limitations, however, dictate that only certain of these types of instruments may be addressed in this Article. In addition, this Article will not address the status of the products at issue under federal banking law or state law, including insurance laws, each of which similarly warrant separate treatment.

3. 7 U.S.C. §§ 1-24 (1982). The CEA establishes an extensive set of registration requirements, as well as substantive prohibitions and reporting obligations, which are imposed upon brokers and traders. The CFTC's exclusive jurisdiction is established in 7 U.S.C. § 2a (1982 & Supp. III 1985). The CFTC was created in 1974, by amendments to the CEA, which also extended the coverage of the CEA to all previously unregulated commodities. *See* Commodity Futures Trading Commission Act of 1974 § 102, Pub. L. No. 93-463, 88 Stat. 1389 (1974). The original CEA had been enacted in 1936. Commodities Exchange Act, Ch. 545, 49 Stat. 149(1) (1936). For a discussion of the commodity futures markets and the nature and purposes of commodity trading, see Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Curran, 456 U.S. 353 (1982); CFTC REPORT TO THE CONGRESS IN RESPONSE TO SECTION 21 OF THE COMMODITY EXCHANGE ACT (1980). *See also* Markham & Gilberg, *Federal Regulation of Bank Activities in the Commodities Markets*, 39 BUS. LAW. 1719 (1984).

4. 7 U.S.C. § 6d (1982 & Supp. III 1985). The primary function of an FCM is to solicit customer orders and accounts and to accept customer funds for trading on behalf of customers on designated contract markets. FCMs may conduct their operations through a sales force of employees, who must be registered with the CFTC as associated persons and are the equivalent of registered representatives of a securities broker-dealer. 17 C.F.R. § 3.12 (1986). In the alternative, an FCM may operate through an independent sales force made up of introducing brokers, who are registered separately under the CEA. *See* Horwitz & Gilberg,

minimum net capital at all times, segregate customers' funds and securities, and prepare and retain detailed books and records of their operations.[5] FCMs that also are members of contract markets are subject to additional regulatory requirements imposed by the exchanges.[6] FCMs that are not members of any contract market must execute transactions on behalf of customers by clearing them through a member firm.

The CFTC also regulates the activities of commodity trading advisors, commodity pool operators, and floor brokers, among other individuals and entities.[7] Moreover, the CFTC exercises exclusive jurisdiction with respect to exchange traded futures contracts and certain option contracts.[8] As a result, the states are statutorily prohibited from substantively regulating the activities of firms and individuals in these areas. State common law and anti-

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Introducing Brokers Under The Commodity Exchange Act: A New Category of Commodity Professionals, 40 WASH. & LEE L. REV. 907 (1983). The term "contract market" is a statutory term of art referring only to United States commodities exchanges regulated by the CFTC. *See* Horwitz & Markham, *Sunset on the Commodity Futures Trading Commission: Scene II*, 39 BUS. LAW. 67 (1983); Johnson, *The Commodity Futures Trading Commission: Newest Member of Each Exchange's Management Team*, 34 FED. B. J. 173 (1975); Markham & Schobel, *Commodity Exchange Act Rule Approval—Procedural Mishmash or Antitrust Umbrella?*, Antitrust & Trade Reg. Rep. (BNA) No. 746 (Special Supp.) (Jan. 13, 1976). Contract markets operate as self-regulatory exchanges, with their own rules and disciplinary procedures, subject to supervision and control by the CFTC.

5. FCMs generally must maintain a minimum net capital of $50,000 at all times. 7 U.S.C. § 6d (1982 & Supp. III 1985); 17 C.F.R. § 1.17 (1986). A firm's net capital is defined according to a complex formula, similar to that applicable to registered broker-dealers under the securities laws. *See* Markham & Gilberg, *supra* note 3, at 1750-52. The record keeping requirements are set forth in CFTC regulations. 17 C.F.R. §§ 1.31-.40 (1986). With respect to FCM segregation requirements, see Markham & Gilberg, *supra* note 3, at 1752-53.

6. *See generally* Markham & Schobel, *Self-Regulation Under The Commodity Exchange Act—Can The CFTC Make It Work?*, Sec. Reg. & L. Rep. (BNA) No. 368 (Special Supp.) (September 1, 1976).

7. 7 U.S.C. §§ 2a, 6m (1982 & Supp. III 1985). The definition of a commodity trading advisor generally encompasses any person rendering advice about the value of, or the advisability of trading in, any CFTC-regulated instruments, thereby encompassing persons managing accounts on a discretionary basis as well as those dispensing "passive" forms of advice. Prior to amendments to the CEA in 1982, however, the term was defined much more broadly. It included any person rendering advice about the value of commodities—not merely futures, options or other CFTC-regulated instruments. *See* Horwitz & Markham, *supra* note 4, at 86-87. The term "commodity pool operator" encompasses any person managing a pooled vehicle for the trading of CFTC-regulated instruments, subject to a number of exemptions. 17 C.F.R. § 4.13 (1985). Commodity trading advisors and commodity pool operators themselves are subject to a separate, although less extensive, regulatory scheme. *See* Mitchell, *The Regulation of Commodity Trading Advisors*, 27 EMORY L.J. 957 (1978); Rosen, *Regulation of Commodity Pool Operators Under The Commodity Exchange Act*, 40 WASH. & LEE L. REV. 937 (1983).

8. *See infra* notes 10-36.

fraud statutes, however, remain applicable, and with respect to off-exchange instruments, the states retain concurrent jurisdiction with the CFTC.[9]

A. *Futures Contracts*

In general, a futures contract is a contractual obligation between two parties to make and receive delivery, respectively, of a stated quantity of a commodity at a fixed price in a future delivery month.[10] Futures contracts are traded on the basis of "margin" deposits, which essentially are good faith performance bonds intended to assure the performances of the parties to the contracts.[11] Both the purchaser and seller of the underlying commodity must make deposits upon entering into the contract, known as "original" or "initial" margin, and may be required to make additional payments, known as "maintenance" or "variation" margin, as the market moves adversely to their positions.[12] Conversely, the holder of a futures contract may be entitled to receive payments of variation margin in the event that the market moves in a favorable direction.

Although all futures contracts create binding obligations on the parties to make and receive delivery, respectively, of an underlying commodity or a cash settlement, a trader may "offset" or "liquidate" a position, without actually making or accepting delivery, by entering into an equal and opposite obligation.[13] After a final settlement of variation margin, the trader then either receives or pays the difference in the value of the contract. Of course, in a small number of instances, the parties to a futures contract actually make and receive delivery of the underlying commodity, although some contracts result in a cash settlement rather than physical delivery. In an overwhelming number of cases, however, positions are closed out by offset prior to the time specified for delivery. This high incidence of settlement by liquidation occurs because futures contracts are traded primarily for the purpose of

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9. *See infra* notes 308-10 and accompanying text. *See also* Gilberg, *Precious Metals Trading—The Last Frontier of Unregulated Investment*, 41 WASH. & LEE L. REV. 943, 985-91 (1984); Horwitz & Markham, *supra* note 4, at 76-80.

10. *See* CHICAGO BOARD OF TRADE, COMMODITY TRADING MANUAL (1982); 1 P. JOHNSON, COMMODITIES REGULATION § 1.05 (1982).

11. P. JOHNSON, *supra* note 10, at §§ 1.05, 1.10; T. RUSSO, REGULATION OF THE COMMODITY FUTURES AND OPTIONS MARKETS §§ 2.03-2.04 (1983).

12. P. JOHNSON, *supra* note 10, at § 1.10.

13. *Id.*

hedging price risks or speculating against price fluctuations, rather than for purchasing or selling physical commodities.[14] As a result, traders ordinarily are interested only in obtaining cash payments of price differentials, not actual commodities.

For example, a farmer anticipating the production of a soybean crop in a future month may wish to assure that the price he receives at that time is not less than the market price projected for the time of delivery. In order to do so, the farmer may enter into a futures contract to sell a stated quantity of soybeans at a fixed price in a particular delivery month, known as a "short" position. If prices decline between the time of contract and the time of delivery, the farmer will have protected himself by "locking in" the higher price. If prices rise, the farmer will have foregone a portion of the higher price received for his crop because of the cost of entering into and liquidating the futures position, but will still profit and will have been protected from price drops. Conversely, a soybean user who is concerned about a price rise before the time he acquires the commodity may enter into a futures contract to buy soybeans, a "long" position. If the price increase does occur, the user will have "locked in" the lower price.

With the development of financial futures contracts in the 1970s, including contracts on debt obligations, foreign currencies, indexes, and other products, these types of hedging opportunities became available to institutions and other participants in the financial markets as well.[15] For example, a portfolio manager with a debt instrument portfolio may wish to hedge against a rise in interest rates, which would cause a decline in the portfolio's value. This hedging can be accomplished by entering into a contract to sell Treasury bonds at a fixed price in a stated delivery month. If interest rates do rise, the portfolio manager may be able to offset the decline in value of portfolio securities in whole or in part by profits earned on the Treasury bond futures. The same opportunity is available to institutional investors with broad-based equity

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14. *Id.*

15. Yeutter, *Futures Trading in the 1980's, Special Report, The Futures Markets and National Policy: An Agenda for the 1980s*, Nat'l J., Sept. 24, 1983, at 64-66. *See also* Comptroller of the Currency, Trust Banking Circular No. 79 (April 19, 1983); Comptroller of the Currency, Trust Banking Circular No. 14 (October 16, 1981); Fitzgerald, *Innovations in Financial Futures*, BANKER, April 1983, at 95; Horwitz & Markham, *supra* note 4, at 67-69; Markham & Gilberg, *Washington Watch*, 6 CORP. L. REV. 59, 61 (1983); Weiner, *The Hedging Rationale For A Stock Index Futures Contract*, 1 J. FUT. MKT. 59 (1981); Vernon, *Stock Index Futures: Is There Life After Death For The Securities Markets*? 35 BUS. LAW. 823 (1980).

security portfolios through the purchase and sale of futures contracts on stock indexes. In addition, as in the case of agricultural futures, a "long" position in financial futures contracts can protect against a rise in the price of the securities or currencies to be acquired.

The CEA prohibits the offer and sale of any futures contract other than on a designated contract market. The Act also provides the CFTC with exclusive jurisdiction to enforce this prohibition.[16] Moreover, with the development of financial futures, Congress amended the CEA definition of a "commodity" to include financial instruments and all other goods and services on which futures contracts may be offered, and thus brought these products within the exclusive jurisdiction of the CFTC as well. These amendments, as discussed more fully below, have triggered an ongoing jurisdictional battle between the CFTC and the SEC.[17] Nevertheless, despite the generally accepted description of a "futures contract" set forth above, neither the CEA nor the CFTC regulations contain a precise definition. As a result, the construction of the term has been left to CFTC and judicial interpretation.

The CEA does state, however, that the prohibition on off-exchange futures trading does not extend to "forward" contracts, or "deferred delivery" contracts on commodities: "[T]he term 'contract for future delivery' . . . shall not include any sale of any cash commodity for deferred shipment or delivery."[18] This exclusion was inserted into the original CEA in 1936, in order to assure that commercial transactions involving future delivery of actual commodities would not be within the scope of the statute.[19] Although the statute does not precisely articulate the distinction between forward contracts and futures contracts, Congress clearly intended to exclude standard agreements between commercial entities involving delivery of physical commodities at a later date from the prohibition on off-exchange futures trading.[20]

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16. 7 U.S.C. § 4a (1982 & Supp. III 1985).

17. *See* Johnson, *The Perimeters of Regulatory Jurisdiction Under The Commodity Futures Trading Commission Act*, 24 DRAKE L. REV. 61 (1975); Note, *The Role of the Commodity Futures Trading Commission Under the Commodity Futures Trading Commission Act of 1974*, 73 MICH. L. REV. 710 (1975).

18. 7 U.S.C. § 2 (1982); Committee on Commodities Regulation of the Association of the Bar of the City of New York, *The Forward Contract Exclusion: An Analysis of Off-Exchange Commodity-Based Investments*, 41 BUS. LAW. 853, 856-63 (1986) [hereinafter City Bar Report].

19. City Bar Report, *supra* note 18, at 859.

20. *Id.*

In delineating the relative characteristics of futures and forward contracts, the CFTC and the courts have focused principally on the commercial character of the latter and on whether delivery of physical commodities ordinarily occurs. In particular, the CFTC's Office of General Counsel (OGC) stated in an early internal memorandum that

> (1) Congress intended generally to prohibit any public marketing of contracts for the future delivery of commodities—in the plain and literal meaning of that phrase—except through the facilities of a designated contract market, and (2) this complete prohibition was intended to be subject to an exception solely for the benefit of persons involved in a commercial cash commodity business, which would allow them to effect cash sales of the commodity, contemplating actual delivery as a matter of course, but in which delivery of the commodity might be deferred for the purposes of commercial convenience or necessity.[21]

The CFTC subsequently amplified this conclusion in *In Re Stovall*,[22] which for many years represented the CFTC's clearest and most complete articulation of its definition of a futures contract. In essence, the CFTC stated that the CEA's deferred delivery exemption "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."[23] In addition, the CFTC identified four "classic" elements of futures contracts, which, although not strictly required in every case, evidence the existence of such an instrument: (1) the standardization of contract terms; (2) instruments "directly or indirectly offered to the general public"; (3) transactions that are "generally secured by earnest money or 'margin' "; and (4) transactions "that are entered into primarily for the purpose of assuming or shifting the risk of changes in the values of commodities rather than for transferring ownership of the actual commodities."[24] A number of post-*Stovall* decisions, rendered by the CFTC as well as the courts, have reiterated and elaborated upon this definition.[25]

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21. Memorandum of CFTC Office of the General Counsel, *reprinted in* [1977-1980 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 20,772 (Exhibit 1) (1978).

22. [1977-1980 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 20,941 (1979).

23. *Id.* at 23,777.

24. *Id.*

25. CFTC v. Co Petro Marking Group, Inc., 680 F.2d 573 (9th Cir. 1982); CFTC v. National Coal Exch., Inc., [1980-1982 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 21,424 (W.D. Tenn. 1982); *In re* First Nat'l Monetary Corp., [1982-1984 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 21,707 (CFTC 1983); Jackson v. American Gold Dealers Ass'n, [1982-1984 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 21,956 (CFTC 1983); CFTC v. Commercial Petrolera Internacional, S.A., [1980-1982 Transfer Binder] Comm. Fut. L. Rep. (CCH)

Recently, the OGC has issued a number of interpretive releases that, while reaffirming the *Stovall* criteria, have placed greater reliance on whether delivery is required and ordinarily occurs as a matter of course under a particular type of contract. In one instance, the OGC stated that futures contracts evidence one or a combination of the following characteristics: they involve the purchase or sale of a commodity for future delivery for a price determined at the time of contract; they contain standardized terms; they are entered into not for the purpose of transferring ownership but for hedging or speculation; and they are settled ordinarily by offset or liquidation.[26] These elements, of course, represent the traditional criteria relied upon by the courts and the CFTC.

The OGC also implied, however, that these factors have been relegated to secondary importance and that the principal determination on the question of whether a futures contract is present will be made on the basis of delivery.[27] For example, if delivery is intended and regularly occurs under a certain type of arrangement, the CFTC is less likely to find that the instrument is a futures contract, even if the contracts are standardized, margined, and so forth. Conversely, the absence of these features no longer may pre-

¶ 21,222 (CFTC 1981). In *Stovall*, however, the CFTC noted that the elements set forth were not "an exhaustive catalogue of factors in determining whether an instrument is a futures contract." In re *Stoval* at 23,778-79. To the contrary, the CFTC and the courts repeatedly have held that, like the court's approach in determining the existence of a "security," the identification of a futures contract depends upon a review of all the circumstances of a particular case. In In re *First Nat'l Monetary Corp.*, the CFTC found that "forward" contracts offered by two precious metals dealers were "of standardized form, providing for delivery of a given quantity of precious metals at a date in the future at a price fixed at the outset of the transaction." *First Nat'l Monetary* at 26,771. In addition, customers could take long or short positions with the dealer acting as principal in every transaction. The initial deposit made by the customer, which represented a percentage of the total purchase price, was variable at the dealer's discretion and, if the equity in the customer's account fell below a specific maintenance level, additional funds could be required. *Id.* Similarly, in *Jackson* tbe dealer offered a "casb forward contract" which exhibited similar features. *Jackson* at 28,119.

26. The Regulation of Leverage Transactions and Other Off-Exchange Future-Delivery Type Investments—Statutory Interpretation, *reprinted in* [1984-1986 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 22,518 (Marcb 25, 1985); OGC Interpretive Letter No. 85-2, [1984-1986 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 22,673 (August 6, 1985).

27. *See* OGC Interpretive Letter No. 85-2, *supra* note 26, at ¶ 22,673. The principal focus of the discussion in these interpretive releases and letters has been the question of whether the parties intended delivery, and whether delivery ordinarily occurs as a matter of course. In fact, in one release cited above, the traditional characteristics of a futures contract were relegated to a footnote. The Regulation of Leverage Transactions and Otber Off-Exchange Future-Delivery Type Investments—Statutory Interpretation, *reprinted in* [1984-1986 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 22,518, at 30,261 n.2 (March 25, 1985).

vent a finding of a futures contract if delivery is unlikely. Although the CFTC has not abandoned explicitly the "classic" definition of a futures contract, recent statements indicate a shift away from it, and therefore the state of the law is at best unclear.

Notably, many financial instruments may be subject to a further exclusion from the prohibition on off-exchange futures trading, regardless of whether they are found to constitute permissible forward contracts. This so-called "Treasury Amendment," included in the CEA by Congress in 1974 at the Treasury Department's request, was designed to assure that the CEA and the exclusive jurisdiction of the CFTC would not disrupt unduly the operations of large institutions in the financial markets.[28] The amendment provides that

> [n]othing in this Act shall be deemed to govern or in any way be applicable to transactions in foreign currency, security warrants, securities rights, resales of installment loan contracts, repurchase options, government securities or mortgages and mortgage purchase commitments, unless such transactions involve the sale thereof for future delivery conducted on a board of trade.[29]

Although the legislative history of the Treasury Amendment is unclear, it has been argued in several instances that the Amendment was intended to exclude *all* trading in financial instruments from the scope of the CEA, unless that trading takes place on a

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28. *See* S. REP. No. 1131, 93d Cong., 2d Sess. 49-51, *reprinted in* 1974 U.S. CODE CONG. & ADMIN. NEWS 5843, 5887.

29. 7 U.S.C. § 2 (1982 & Supp. III 1985). The Treasury Amendment was included in the statute in response to a letter submitted by the Department of the Treasury, to the Senate Committee on Agriculture, Nutrition and Forestry. In that letter, the Treasury argued that, in the absence of a provision excluding transactions in foreign currency from the scope of the CEA, the statute would have an unintended impact upon the ability of banks and other financial institutions to trade among themselves in foreign currencies and certain financial instruments. *See* Trading in Foreign Currencies for Future Delivery, 50 Fed. Reg. 42,983, 42,985 (1985). The letter also stated:

> The Department feels strongly that foreign currency futures trading, other than on organized exchanges, should not be regnlated by the [CFTC]. Virtually all futures trading in foreign currencies in the United States is carried out through an informal network of banks and dealers. This dealer market, which consists primarily of the large banks, has proved highly efficient in serving the needs of international business in hedging the risks which stem from foreign exchange rate movements. The participants in this market are sophisticated and informed institutions, unlike the participants on *organized* exchanges, which, in some cases, include individuals and small traders who may need to be protected by some form of governmental regulation.

Letter from Donald L.E. Ritger, Acting General Council, Dep't of the Treasury, to Herman E. Talmadge, Chairman, Comm. on Agriculture and Forestry (July 30, 1974), *reprinted in* S. REP. No. 1131, 93d Cong., 2d Sess. 49-50, *reprinted in* 1974 U.S. CODE CONG. & ADMIN. NEWS 5843, 5887.

regulated exchange.[30] Under this line of reasoning, neither the nature of the instruments nor the types of participants in the transactions are material considerations; that the product is based upon one of the commodities identified in the Treasury Amendment is sufficient to remove the instrument from both the off-exchange trading prohibition and the CFTC's jurisdiction.

In this regard, the legislative history of the Treasury Amendment states that the statute is "not applicable to trading in foreign currencies and certain enumerated financial instruments unless such trading is conducted on a formally organized futures exchange," suggesting that all off-exchange transactions in such instruments are exempt.[31] In addition, the Seventh Circuit accepted this argument, at least in part, when it decided in 1984 that contracts for the forward purchase and sale of Government National Mortgage Association (GNMA) certificates are within the Treasury Amendment and, therefore, outside the CEA's scope unless traded on an organized exchange.[32]

The CFTC, however, relying upon the Treasury Amendment's legislative history, has stated that the Amendment applies only to transactions among "sophisticated and informed institutions," which do not involve offers to and solicitations of members of the general public.[33] In addition, the CFTC has taken the position that a principal premise of the Treasury Amendment is that other regnlatory authorities govern the activities of institutional investors and therefore CFTC regulation is unnecessary. The CFTC also has

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30. *See* Public Comments Filed in Response to Statutory Interpretation and Request for Comments, 50 Fed. Reg. 42,983 (1985). In particular, see Letters filed by Cadwalader, Wickersham & Taft (December 23, 1985); Donaldson, Lufkin & Jenrette Securities Corp. (December 20, 1985); Shearson/Lehman Bros. (December 23, 1985); Rosenman, Colin, Freund, Lewis & Cohen (December 23, 1985); Merrill Lynch Futures Inc. and Merrill Lynch International Bank (December 23, 1985). *Id.*

31. S. REP. No. 1131, 93d Cong., 2d Sess. 49-51, *reprinted in* 1974 U.S. CODE CONG. & ADMIN. NEWS 5843, 5887.

32. Abrams v. Oppenheimer Government Securities, Inc., 737 F.2d 582 (7th Cir. 1984). In *Oppenheimer* the court found that, because GNMA certificates are excluded from the CEA, contracts for purchase and sale also are not subject to the statute, unless traded on an organized exchange. The court noted that GNMA forward contracts are not standardized, but are most often the result of face-to-face negotiations between the parties. *Id.* at 590. In addition, the court found that futures and forwards differ with respect to the purpose of the investment and the expectation of investors. *Id.* at 591. It is not entirely clear, therefore, whether the *Oppenheimer* decision rested primarily upon the ground that the transactions were *bona fide* forward contracts, subject to the CEA forward contract exclusion, or that the Treasury Amendment precluded CFTC jurisdiction over the investments unless traded on an organized exchange.

33. 50 Fed. Reg. 42,983, 42,985 (1985).

noted that when the transactions involved are not within the supervision of such authorities, the Amendment is inapplicable.[34] Moreover, the CFTC has concluded that a loosely defined "network" of dealers in financial instruments, although not formally organized as such, may constitute a "board of trade."[35] Consequently, in the CFTC's view its jurisdiction may extend to off-exchange transactions, notwithstanding the Treasury Amendment.

In one recent instance, discussed more fully below, the CFTC issued a release stating that forward transactions in foreign currency traded in the "interbank" market are within the jurisdiction of the CFTC unless: (1) actual delivery of currency generally is made and accepted, so that the "forward" contract exclusion is available; or (2) the transactions occur solely between "sophisticated and informed institutions" and do not involve members of the general public.[36] In the former instance, the CFTC's position is that the instrument is not a futures contract and therefore not subject to the CEA. In the latter instance, although the instrument may be a futures contract, the CFTC stated that the instrument is outside the CEA's scope because of the Treasury Amendment, but only under the circumstances described in the Amendment's legislative history.[37]

B. *CFTC Regulation of Commodity Options*

A commodity option, unlike a futures contract, imposes an obligation on only one party.[38] In particular, an option contract provides one party with the right, but not the obligation, to purchase or sell a stated quantity of a commodity or to enter into a futures contract for a fixed price at any point before a specified

34. *Id.*

35. CFTC Office of General Counsel, Interpretive Letter No. 77-12, *reprinted in* [1977-1980 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 20,467 (August 17, 1977). In that instance, the OGC stated that a loosely defined network of dealers in GNMA certificates could constitute a "board of trade," although not formally organized as such, particularly if offers and sales were made to members of the general public.

36. Trading in Foreign Currencies for Future Delivery, 50 Fed. Reg. 42,983 (1985). The release, however, did not define the meaning of the terms "sophisticated and informed institutions," but rather solicited public comment on this issue. The release stated only that products marketed to the general public, which are not encompassed within the forward contract exemption from the CEA, are outside the scope of the Treasury Amendment and therefore within the CFTC's jurisdiction.

37. *Id.* As discussed below, the CFTC since has retreated from that position. *See infra* notes 240-49 and accompanying text.

38. *See* CFTC, Glossary of Trading Terms 4, 19-20 (1983).

future date.[39] Upon exercise of the option, the purchaser, or "holder," either must pay the exercise price and receive delivery of the commodity (a "call" option) or must deliver the commodity and receive payment (a "put" option). In contrast, the seller, or "writer," of the option has no ability to determine whether, or at what point, the option will be exercised, but is obligated to make or receive delivery once the exercise occurs. In addition, in contrast to futures contracts trading, which is conducted on the basis of initial and variation margin payments,[40] an option holder pays a one-time nonrefundable fee, known as the "premium," for the option, but is not liable for any additional amounts. The writer, however, generally is subject to initial and variation margin payments as a result of the writer's potentially unlimited exposure.[41]

The Second Circuit has identified a commodity option based on three characteristics: (l) the purchaser has the right to make or take delivery of the underlying commodity; (2) the initial charge for the option is a nonrefundable premium, which represents the maximum amount of the purchaser's out-of-pocket loss; and (3) the purchaser can profit only if the price of the underlying commodity moves sufficiently to cover the amount of the premium and related costs.[42] Although options may have varying characteristics

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39. *Id.*

40. *See supra* notes 10-36 and accompanying text.

41. CFTC, *supra* note 38, at 19-20. For a general discussion of the nature, history and regulatory status of commodity options see Lower, *The Regulation of Commodity Options*, 1978 DUKE L. J. 1095; Markham & Gilberg, *Stock and Commodity Options—Two Regulatory Approaches and Their Conflicts*, 47 ALBANY L. REV. 741 (1983); Schobel & Markham, *Commodity Options—A New Industry Or Another Debacle?*, Sec. Reg. & L. Rep. (BNA) No. 347 (Special Supp. 1976). An option on a futures contract provides the holder with the right to enter into a long futures position (in the case of a call option) or a short position (in the case of a put option) at a fixed price. CHICAGO BOARD OF TRADE, OPPORTUNITIES IN OPTIONS ON U.S. TREASURY BOND FUTURES (1982); COMMODITY EXCHANGE, INC., OPTIONS ON COMEX GOLD FUTURES (1982).

42. United States v. Bein, [1982-1984 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 22,004 (2d Cir. 1984). In *Bein*, the Second Circuit adopted a definition of option contracts previously enunciated by the Southern District of New York:

> Functionally, options are distinguishable from futures contracts and margin sales in at least three significant respects: (1) The initial charge for an option, sometimes called a "contango fee," is a non-refundable premium covering the seller's commission and costs, in contrast to the "down payment" paid in a futures contract or margin sale, which is applied against the ultimate sale price; (2) the option contract gives the purchaser the right to take physical possession of the commodity, but does not obligate him to do so, as a futures or margin contract would; (3) a profit in an option contract accrues only if the price of the commodity rises enough to cover the contango fee (but the losses are limited to the contango fee), while the futures or margin buyer profits if the sale of his right to future delivery exceeds the purchase price (and suffers a loss if the former price is less than the latter price).

in particular instances, these elements constitute the distinctive features of such instruments.[43]

Commodity options also may be traded for hedging or speculative purposes, in a manner similar to futures contracts. For instance, the farmer in the example noted above, instead of taking a "short" position in futures contracts to protect against a price decline, could purchase a "put" option on the underlying crop. This put option would grant the farmer the right, but not the obligation, to sell his crop to the writer for a fixed price at any point before the option's expiration. If the anticipated price decline occurs, the farmer could exercise the option and sell the crop at the predetermined price or perhaps liquidate the option at a profit, which would offset all or a part of the losses incurred in the sale of the physical commodity. Conversely, a user seeking to protect against a rise in the price of commodities could purchase a "call" option, which would provide the user with the right to purchase the commodities at a set price. Commodity options create speculative opportunities as well because either a purchaser or writer, or both, may be speculating against price movements in establishing their respective positions.

Commodity options have been offered in a variety of forms for many years and have a long history of serious abuses, which have brought intense congressional and CFTC scrutiny.[44] Indeed, after options speculation had been blamed in large part for the collapse of the wheat market in the Great Depression, Congress included in the CEA a blanket prohibition on the trading of any options on agricultural commodities then under CEA regulation.[45] For more than thirty years this legislation operated to ban commodity options trading both on and off exchanges.[46]

In the early 1970s, however, a new wave of scandals arose, spearheaded by Harold Goldstein. This twenty-six year old entrepreneur operated an off-exchange options business pursuant to a CEA loophole that applied the options ban only to regulated commodities.[47] Goldstein offered options on "world" commodities such

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Id. at 28,407, *quoting* CFTC v. The United States Metals Depository, 468 F. Supp. 1149, 1155 (S.D.N.Y. 1979).

43. *Bein* at p. 28,407. *See also* Characteristics Distinguishing Cash and Forward Contracts and "Trade" Options, 50 Fed. Reg. 39,656 (1985).

44. *See generally* Markham & Gilberg, *supra* note 41.

45. *Id.* at 759-60.

46. *Id.*

47. *Id.* at 760-61.

as silver, platinum, and coffee, which at that time were unregulated. In fact, however, Goldstein sold "naked" options, because he did not own the commodities on which the options were written. As a result, he could satisfy customer exercises only from his own funds or those of other investors. When the prices of the commodities allegedly underlying the options began to rise substantially, Goldstein was unable to satisfy customer demands and went out of business, leaving millions of dollars of customer losses in his wake.[48]

Following this and similar incidents, Congress amended the CEA in 1974 to include previously unregulated commodities.[49] Congress, however, did not ban options trading on these commodities; instead, it granted the CFTC authority to regulate such trading.[50] Between 1974 and 1978 the CFTC, pursuant to this congressional mandate, adopted regulations that prohibited fraud in connection with options transactions and required FCM registration by brokers offering commodity options.[51] In addition, the CFTC imposed on such brokers the same net capital and segregation requirements applicable to other FCMs, and it also established specific disclosure obligations.[52]

Nevertheless, the options industry continued to be plagued by abuse. In 1978 Congress imposed a moratorium on options trading, but permitted the CFTC to develop a program for exchange traded options.[53] In 1981 the CFTC announced a three year "pilot program" for the trading of options on futures contracts through designated contract markets.[54] This pilot program later was expanded to include options on agricultural and other physical commodities.[55] In 1984 the CFTC increased the number of option contracts a particular contract market may offer, and it ended the pilot pro-

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48. *Id.*

49. *Id.* at 762-63.

50. *Id.*

51. *Id.* at 764-65. *See also* 17 C.F.R. §§ 32.1-.12 (1986).

52. *See* Markham & Gilberg, *supra* note 41, at 765-66.

53. *Id.* at 766-768.

54. Regulation of Domestic Exchange-Traded Commodity Options, 46 Fed. Reg. 54,500 (1981). The pilot program had been proposed originally in 1977 but was not adopted until 1981. General Regulations Under the CEA, 42 Fed. Reg. 55,538, 55,550 (1977); Lower, *supra* note 41, at 1095.

55. Expansion of Pilot Program to include Options on Physicals, 47 Fed. Reg. 56,996 (1982). The inclusion of options on physical commodities in the pilot program was proposed on June 30, 1982, *see* Expansion of Pilot Program Provisions, 47 Fed. Reg. 28,401 (1982), after a court challenge by the American Stock Exchange. *See*, American Stock Exch., Inc. v. CFTC, 528 F. Supp. 1145 (S.D.N.Y. 1982).

gram and made the status of exchange traded commodity options permanent in 1986.[56] Even during the term of the options ban, and to this date, the CEA has permitted off-exchange commodity option trading under certain limited circumstances. First, many physical commodities producers have sold options backed by physical inventory, thereby limiting their risk.[57] In particular, metals processors for many years have written options against metals that they have held in connection with their businesses. The CEA and CFTC regulations, subject to a number of conditions, expressly permit these so-called "dealer" options.[58] These conditions include a requirement that the writer have been in the business of both utilizing the underlying commodity and writing options on the underlying commodity by May 1, 1978; that the writer have a net worth of five million dollars; that the writer issue confirmations and other documents to purchasers; and that the writer comply with a number of segregation, recordkeeping, and disclosure requirements.[59]

CFTC regulations also include an exemption from the options ban for so-called "trade" options, which are options sold to a person who is a producer, processor, or commercial user of the underlying commodity and who purchases the option in connection with his business.[60] A trade option writer's status is irrelevant, although the writer must have a "reasonable basis" to believe that the purchaser is a permissible offeree.[61]

In a no-action letter, the CFTC's Division of Trading and Markets has stated that such a reasonable basis must be grounded in something more than the purchaser's unsubstantiated assertions and that the writer in fact must obtain a written representation about the purchaser's commercial purpose.[62] In addition, the

56. Revisions to Rules for Trading Non-Agricultural Option Contracts and Termination of Pilot Program Status, 51 Fed. Reg. 17,464 (1986).

57. *See* Markham & Gilberg, *supra* note 41, at 769.

58. 7 U.S.C. § 6c (1982 & Supp. III 1985); 17 C.F.R. § 32.12 (1986).

59. 7 U.S.C. § 6c (1982 & Supp. III 1985). *See also* 48 Fed. Reg. 46,797 (1983); Expansion of Pilot Program to include Options on Domestic Agricultural Commodities, 49 Fed. Reg. 2,752 (1984). Specifically, the regulations only permit trade options to be offered on the commodities not enumerated therein. 17 C.F.R. § 32.4(a) (1986).

60. 7 U.S.C. § 6c (1982 & Supp. III 1985); 17 C.F.R. § 32.4 (1986).

61. 7 U.S.C. § 6c (1982 & Supp. III 1985).

62. CFTC Interpretive Letter No. 84-7, *reprinted in* [1982-1984 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 22,025 (February 22, 1984). In that instance, the entity making the request was actually an exchange located in a foreign country. Under the CEA and CFTC regulations, however, options traded other than on a regulated contract market are considered over-the-counter options for regulatory purposes, regardless of whether they are

CFTC staff noted that the purchaser's commercial purpose in acquiring the option must bear a close relationship to the commodity on which the option was purchased.[63] For example, with respect to foreign currencies, the staff held that a trader could not purchase an option on Swiss francs unless it was engaged in a business involving Swiss francs. Nevertheless, the staff stopped short of concluding that an actual hedging purpose is required.[64]

Moreover, the CFTC has requested comment on whether trade option writers also should be required to have a commercial purpose in connection with the options they write.[65] Although the CFTC has taken no definitive action on this point, the adoption of such a requirement could limit substantially the extent to which trade options are written. Furthermore, under the regulations, trade options may not be offered on agricultural commodities.[66] The CFTC has concluded, however, that "hybrid" contracts combining elements of forward delivery agreements and trade options may be entered into on agricultural commodities.[67] For example, a forward contract between commercial entities may include a pricing mechanism that permits one party, based upon a predetermined formula, to receive or pay a higher or lower price at the time of delivery.[68]

C. Leverage Contracts

A leverage contract is a standardized long-term contract for the purchase or sale of a specified quantity of a given commodity that includes, among other things, a percentage payment of the spot price at the outset, periodic payment of a carrying charge or fee on the unpaid balance, and repurchase of the contract from the

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offered from within or without the United States.

63. *Id.* at 28,595.

64. *Id.* In fact, in a subsequent no-action letter to another exchange located outside the United States, the CFTC staff stated that a bona fide hedge transaction, as defined under CFTC regulations, would constitute only one example of a permissible commercial purpose. This, however, was not held to be the only type of permissible trade option. CFTC Division of Trading & Markets, No-Action Letter July 3, 1984. For a further discussion of the trade option exemption, particularly as it relates to options on foreign currency, *see infra* notes 216-229 and accompanying text.

65. *See* Regulations Permitting the Grant, Offer and Sale of Options and Physical Commodities, 50 Fed. Reg. 10,786 (1985).

66. *See* Characteristics Distinguishing Cash and Forward Contracts and "Trade" Options, 50 Fed. Reg. 39,656, 39,657 (1985).

67. *Id.* at 39,660. *See also infra* notes 318-329 and accompanying text.

68. 50 Fed. Reg. 39,656, 39,660 (1985).

customer upon the customer's demand.[69] A leverage dealer acts as a principal and a "market maker" in all transactions with its customers. The dealer reserves the right to cease operating as principal or broker for its customers. A leverage dealer may assure its ability to satisfy commitments to customers by entering into an offsetting futures position (*i.e.*, taking a "long" position when the dealer has an obligation to sell metals to the customer) or by segregating actual metals held in inventory.[70] This inventory, however, may be pledged as collateral for bank loans.

In addition to their limitations on futures and option contracts trading, the CEA and CFTC regulations also substantially restrict the extent to which a person may offer leverage contracts on physical commodities.[71] As in the case of commodity options, the CFTC and Congress at various times have considered either the complete prohibition of leverage transaction trading or the regulation of such instruments as futures contracts.[72] In addition, in 1978 the

69. S. REP. No. 850 95th Cong., 2d Sess. 26, *reprinted in* 1978 U.S. CODE CONG. & ADMIN. NEWS 2087, 2114; CFTC Interpretive Letter No. 81-1, *reprinted in* [1980-1982 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 21,244 (September 16, 1981). *See also* Matthews v. Monex International Ltd., [1977-1980 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 20,791 (1979); Report of the Advisory Committee on Market Instruments to the CFTC on Recommended Policies on Futures, Forward and Leverage Contracts and Transactions, *reprinted in* [1975-1977 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 20,192 (1976).

70. S. REP. No. 850, 95th Cong., 2d Sess. 26, *reprinted in* 1978 U.S. CODE CONG. & ADMIN. NEWS 2087, 2114. The Senate Report specifically described a leverage contract as:

> [A]n agreement for the purchase or sale of a contract for the delivery at a later date of a specified commodity in a standard unit and quality, or the close-out of the contract by an offsetting transaction. The principal characteristics of the contract include: (1) standard units, quality, and terms and conditions; (2) payment and maintenance of 'margin'; (3) close-out by an offsetting transaction or by delivery, after payment in full; and (4) no right or interest in a specific lot of a commodity.

Id.

71. *See* 7 U.S.C. § 23 (1982 & Supp. 1985); 17 C.F.R. §§ 31.1-.26 (1986). Specifically, the CEA prohibits leverage contracts trading on any commodity enumerated under the statute prior to the 1974 amendments. In addition, the Act provides that no person may

> offer to enter into, enter into or confirm the execution of any transaction for the delivery of silver bullion, gold bullion or bulk silver coins or bulk gold coins, under a standardized [leverage] contract . . . contrary to any rule, regulation, or order of the [CFTC] designed to insure the financial solvency of the transaction or prevent manipulation or fraud.

7 U.S.C. § 23(b) (1982 & Supp. III 1985).

72. *See* Greenstone, *Leverage Transactions: On Creating A Regulatory Theme*, 27 EMORY L.J. 909 (1978). The legislative and regulatory history of authority over leverage trading has been marked by continuing attempts by Congress and the CFTC to regulate leverage contracts as futures contracts or to promulgate a separate regulatory scheme. In addition, the SEC at one point attempted to assert jurisdiction over leverage trading by defining a leverage transaction as an "investment contract," under the analysis discussed below, and requiring registration as a security. *See* SEC v. Monex Int'l Ltd., No. 74-3634

CFTC adopted a moratorium on the trading of leverage contracts, although entities already in the business of offering leverage contracts were permitted to continue under a "grandfather" clause in the regulations.[73]

In its 1982 reauthorization process, the CFTC again sought to obtain congressional suspension of leverage trading, but Congress refused.[74] To the contrary, Congress directed the CFTC to regulate, but not prohibit, leverage transactions.[75] Congress also repealed the CEA provision that authorized the CFTC to treat leverage contracts as futures contracts, but permitted the CFTC to prohibit leverage contracts on any commodity if such contracts were not being offered and sold lawfully.[76]

On February 13, 1984, the CFTC issued its "interim" final rules establishing "a comprehensive regulatory scheme designed to govern the offer and sale to the public of leverage transactions for the purchase of silver bullion, gold bullion, bulk silver coins, bulk gold coins, copper, platinum . . . and foreign currencies."[77] Pursuant to its congressional mandate, the CFTC imposed a host of registration, recordkeeping, and financial requirements upon leverage transaction merchants (LTMs), although the full effect of the rules

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(C.D. Cal. 1974). In the 1974 amendments to the CEA, Congress rejected attempts to regulate leverage contracts as futures contracts but directed the CFTC to regulate them separately under its delegated authority. *See* H. R. REP. No. 1383, 93d Cong., 2d Sess. 39, *reprinted in* 1974 U.S. CODE CONG. & ADMIN. NEWS 4853, 4900. The CFTC, however, did not choose to regulate leverage contracts, although it did promulgate a separate anti-fraud rule for leverage contracts in 1975. 17 C.F.R. § 31.3 (1986).

73. 17 C.F.R. §§ 31.1-.2 (1986); *see also* Temporary Moratorium Regarding Gold and Silver Leverage Transactions, 43 Fed. Reg. 56,885 (1978); Temporary Moratorium Regarding Leverage Transactions on Commodities other than Gold and Silver Bullion and Bulk Coins, 44 Fed. Reg. 55,820 (1979).

74. H.R. REP. No. 964, 97th Cong., 2d Sess. 51 *reprinted in* 1982 U.S. CODE CONG. & ADMIN. NEWS 3871, 4069. Congress indicated that it did not object to the CFTC's moratorium, provided that the CFTC would be able "quickly" to adopt a comprehensive regulatory scheme governing leverage trading. Congress also noted that it did not wish to adopt the moratorium by statute, because its grandfather provisions "are inherently anti-competitive and thus contrary to the fundamental objectives of economic competition in the free market place." *Id.*

75. H.R. REP. No. 964, 97th Cong., 2d Sess. 50, *reprinted in* 1982 U.S. CODE CONG. & ADMIN. NEWS 3871, 4068.

76. *Id.* at 51, 1982 U.S. CODE CONG. & ADMIN. NEWS at 4069.

77. Regulations of Certain Leverage Transactions, 49 Fed. Reg. 5,498 (1984). The CFTC's release noted that although it was adopting final rules, these rules were deemed to be "interim" for two reasons. First, the CFTC bad maintained its moratorium on the regulated leverage business until it had an opportunity to evaluate the efficacy of its rules. Second, the CFTC indicated its intention to solicit additional comments on whether leverage transaction merchants should be permitted to offer customers the opportunity to take "short" positions in leverage contracts as well. *Id.*

will not be felt immediately because the CFTC has maintained the temporary moratorium on leverage trading.[78] As adopted, the regulations require persons engaged in leverage transactions to register, a procedure that closely parallels the registration scheme for FCMs.[79] In addition, "leverage commodities" upon which alader, Wickersham & Taft (December 23, 1985); Donaldson, Lufkin & Jenrette Securities Corp. (December 20, 1985); Shearson/L.6 (1986). Because futures contracts may be traded only on registered contracts markets, no registration process analogous to SEC registration of securities has existed in the commodities market. The registration of leverage commodities thus represents a departure from this practice. Furthermore, net capital, segregation, reporting, and recordkeeping requirements similar to those imposed upon FCMs are mandatory for LTMs.[81]

LTMs also are governed by specific antifraud rules under CFTC regulations, and the CFTC, as well as the courts, has provided relief to private customers who have been defrauded by leverage dealers.[82] Indeed, numerous decisions in recent years have found violations of these rules by leverage merchants offering precious metals through "boiler room" operations.[83] These operations have tainted the reputation of the leverage industry.

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78. *Id.* The regulations set forth for the first time a comprehensive definition of leverage contracts. *See* 17 C.F.R. § 31.4(w) (1986).

79. 17 C.F.R. § 31.6 (1986). The regulatory scheme adopted for LTMs and leverage trading is substantially similar to that imposed upon FCMs and other regulated commodities professionals. For example, LTMs must register with the CFTC, and any employees engaged in the solicitation or acceptance of customer accounts, or in the supervision of persons so engaged, must register as associated persons. 17 C.F.R. §§ 3.17, 3.18 (1986). In addition, LTMs are subject to recordkeeping and reporting requirements roughly analogous to those established with respect to FCMs. *See* 17 C.F.R. §§ 31.14-.15 (1986). Further, LTMs must maintain a minimum adjusted net capital of two-and-one-half million dollars, plus twenty percent of the market value of the physical commodities subject to uncovered leverage contracts. 17 C.F.R. § 31.7 (1986). LTMs, in addition, are required to prepare a disclosure document along the lines of that commodity trading advisors prepare, a requirement that is not imposed upon FCMs. *See* 17 C.F.R. § 4.31 (1986).

81. *Id.* at §§ 31.7-31.17.

82. *Id.* at § 31.3. *See generally* CFTC v. Premex, Inc., [1980-1982 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 21,229 (7th Cir. 1981); Thielker v. Bonaire Trading Corp., [1980-1982 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 21,404 (CFTC 1982); Adoption of Anti-Fraud Rules, *reprinted in* [1975-1977 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 20,049 (June 17, 1975).

83. Moreira v. First National Monetary Corp., [1982-1984 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 21,914 (CFTC 1983); Campbell v. International Precious Metals Corp., [1982-1984 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 21,816 (CFTC 1982); Mitehell v. Premex, Inc., [1982-1984 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 21,678 (CFTC 1983).

In 1986 reauthorization of the CFTC again came before Congress. Rejecting proposals to ban leverage transactions completely, Congress instead adopted amendments to the CEA that prohibit leverage contracts only on commodities other than precious metals.[84] In addition, the amendments impose a moratorium on new entrants into the market, pending completion of a CFTC study.[85] At that time, the leverage industry will be opened to new participants, subject to new CFTC regulations.[86]

III. THE SECURITIES INDUSTRY

The securities industry encompasses numerous types of financial instruments and institutions and includes a far broader range of activities and persons than the commodities industry. In many respects, the two industries and regulatory schemes parallel each other and, as discussed below, even overlap in several significant areas. Nevertheless, there are many fundamental distinctions between them that have resulted in divergent statutory and regulatory treatment, often of the same or similar instruments.

Primarily, the SEC regulates the securities industry although, unlike the CFTC, the SEC does not retain exclusive jurisdiction over all securities trading.[87] To the contrary, the states have concurrent authority to regulate transactions in securities and related activities within their borders.[88] SEC jurisdiction, therefore, is exclusive only at the federal level. In contrast to the trading of futures contracts, however, which may be conducted only on a regulated contract market, securities transactions may take place over the counter and in a range of contexts well beyond the floor of a national securities exchange.[89] As a result, SEC jurisdiction, despite its nonexclusivity, is in many ways substantially greater than CFTC jurisdiction.[90]

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84. H.R. REP. No. 995, 99th Cong., 2d Sess. 14 (1986). The CFTC itself had proposed removing leverage contracts from the scope of its jurisdiction entirely. *See* H.R. REP. No. 624, 99th Cong., 2d Sess. 13-14, 27. The result of the change, had it been enacted, presumably would have been to permit the CFTC to prohibit leverage contracts only where they in fact constituted off-exchange futures contracts.

85. H.R. REP. No. 995, 99th Cong., 2d Sess. (1986).

86. *Id.* At present, only two firms lawfully are engaged in a leverage business and registered pursuant to CFTC regulations.

87. *See* L. LOSS, FUNDAMENTALS OF SECURITIES REGULATION 27-29 (1983).

88. *Id.* at 27-29.

89. *Id.* at 674-76.

90. In addition, the SEC retains corporate finance jurisdiction over any domestic corporation meeting certain reporting requirements, thereby imposing substantive SEC regulation on thousands of entities not involved in securities-related businesses. *See id.* at 487-92.

The securities industry is governed by four principal statutes: The Securities Act of 1933 (the Securities Act), covering the issuance, offer, and sale of securities;[91] The Securities Exchange Act of 1934 (the Exchange Act), covering regulation of brokerage firms, exchanges, and transactions in securities;[92] The Investment Company Act of 1940, regulating mutual funds and other types of pooled investment vehicles;[93] and The Investment Advisers Act of 1940 (the Advisers Act), governing the activities of investment advisers.[94]

Each of these statutes establishes a comprehensive set of regulatory requirements. The Exchange Act and SEC regulations require the registration as a broker-dealer of any person "engaged in the business of effecting transactions in securities, but [this requirement] does not include a bank," although there are exemptions to this requirement.[95] Broker-dealers are subject to a pervasive regulatory scheme that includes net capital, reserve, and recordkeeping requirements, which in fact served as the model for CFTC regulations governing FCMs.[96] Many other aspects of SEC regulation also parallel CEA and CFTC jurisdiction, such as the regulation of advisers, exchanges, and pooled investment vehicles.[97]

Securities themselves, however, and the manner in which their trading is regulated, contrast sharply with the structure of futures contracts and their treatment under the CEA. Unlike a futures contract, a security represents not a contractual arrangement on underlying goods or articles, but, broadly speaking, an interest of

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91. 15 U.S.C. §§ 77a-77aa (1982).

92. *Id.* §§ 78a-78kk.

93. *Id.* §§ 80a-1 to 80a-64.

94. *Id.* §§ 80b-1 to 80b-21.

95. *Id.* § 78(C)(a)(4). *See* N. WOLFSON, R. PHILLIPS & T. RUSSO, REGULATION OF BROKERS, DEALERS AND SECURITIES MARKETS ¶ 1.04 (1977) [hereinafter WOLFSON]. In this regard, it should be noted that a determination that a particular type of financial instrument constitutes a security within the meaning of the federal securities laws could result in a requirement that it be offered and sold solely by a registered broker-dealer. 15 U.S.C. § 70 (1982). As noted, under the CEA, futures contracts may be traded only by and through registered FCMs. Under the securities laws, however, as discussed more fully below, securities may be traded over-the-counter as well as on registered exchanges. As a result, although permissible off-exchange transactions in most instances will not require the seller to register as an FCM, they in some instances could result in a requirement that such person register as a broker-dealer.

96. WOLFSON, *supra* note 95, at ¶¶ 6.01-.15. *See also* Wolfson & Guttman, *The Net Capital Rules for Brokers and Dealers*, 24 STAN. L. REV. 603 (1972); FERRALL, CAPITAL AND BOOKKEEPING RULES (1962).

97. L. LOSS, *supra* note 87, at 54-63, 689-94, 733-45; T. RUSSO, REGULATION OF THE COMMODITY FUTURES AND OPTIONS MARKETS §§ 1.01-1.62, 5.01-5.16 (1985).

some sort in an enterprise or business. As a result, a trader's profit or loss depends more on the success of that enterprise than on the price fluctuations of goods or instruments that may or may not have any relationship to the parties to the transaction.

Moreover, because of this fundamental structural distinction, the securities laws and SEC regulations are concerned not only with the manner in which securities are traded, but even more so with the types and distribution of information provided to prospective investors. In particular, although the CEA prohibits futures transactions and most option transactions not entered into on a board of trade, the Securities Act requires *registration* of any offering of securities, subject to a number of exemptions.[98] The basic regulatory approach, therefore, is significantly different.

The question of whether a given instrument constitutes a security consequently will determine not whether it may be offered, but, in most instances, the manner in which it may be offered.[99] Nevertheless, given the extensive obligations the Securities Act imposes upon an issuer of a registered offering of securities, the registration requirement may operate as a practical prohibition on the offering.[100] In one respect, however, the securities and commodities industries share a common feature—in many instances, it is no easier to determine the presence of a security than it is to identify a futures contract.

A. *The Securities Act Definition of a Security*

The Securities Act broadly defines a security to include:

> any note, stock, treasury stock, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit sharing agreement, collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit for a security, fractional undivided interest in oil, gas, or other mineral rights, any put, call, straddle, option, or privilege on any security, certificate of deposit, or group or index of securities (including any interest tberein or based on the value thereof), or any put, call, straddle, option, or privilege entered into on a national securities exchange relating to foreign currency, or, in general, any interest or instrument commonly known as a "security," or any certificate of interest or participation in, temporary or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase, any of the

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98. *See* L. Loss, *supra* note 87, at 81-165, 263-296.

99. *Id.*

100. In particular, Securities Act registration generally requires preparation of a detailed registration statement disclosing the financial condition and other aspects of the issuer's business. *See id.* at 92-166. In addition, the issuer must comply with applicable state "blue sky" statutes, which may require registration of the offering in one or more states.

foregoing.[101]

This definition has been the subject of extensive judicial and legal debate and has spawned probably the most extensive literature in the areas of securities and commodities regulation.[102] Indeed, each one of the terms set forth above at one time or another has been the subject of a substantial legal subindustry, as the SEC, the courts, and the financial community have described and categorized different types of financial arrangements. Three of the items included in the statutory definition, however, are of principal interest here: investment contracts; notes or other evidences of indebtedness; and options, warrants, or rights to subscribe to or purchase securities.

1. Investment Contract Analysis

The majority of attention focused on the definition of a security has been on the construction of the term "investment contract" under the Securities Act. In a landmark decision, *SEC v. W.J. Howey Co.*, [103] the Supreme Court held that "an investment contract for purposes of the Securities Act means a contract, transaction or scheme whereby a person invests his money in a common enterprise and is led to expect profits solely from the efforts of the promoter or a third party."[104] In *Howey* the owner of some Florida

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101. 15 U.S.C. § 77h(1) (1981 & Supp. III 1985). The other principal statutes of the federal securities laws contain similar definitions of a "security." *See, e.g.*, 15 U.S.C. § 78c(a)(10) (1981 & Supp. III 1985).

102. *See, e.g.*, Arnold, *"When Is a Car a Bicycle?" and Other Riddles: The Definition of a Security Under the Federal Securities Laws*, 33 CLEV. ST. L. REV. 449 (1984-85); Darrell, *Redefining a "Security": Is the Sale of a Business Through a Stock Transfer Subject to the Federal Securities Laws?*, 12 SEC. REG. L.J. 22 (1984); Deacon & Prendergast, *Defining a "Security" After the Forman Decision*, 11 PAC. L.J. 213 (1980); FitzGibbon, *What Is A Security?—A Redefinition Based on Eligibility to Participate in the Financial Markets*, 64 MINN. L. REV. 893 (1980); Lipton & Katz, *"Notes" Are Not Always Securities*, 30 BUS. LAW. 763 (1975); Lowenstein, *The Commercial Paper Market and the Federal Securities Laws*, 4 CORP. L. REV. 128 (1981); Newton, *What is a Security? A Critical Analysis*, 48 MISS. L.J. 167 (1977); Orbe, *A Security: The Quest For a Definition*, 12 SEC. REG. L.J. 220 (1984); Sonnenschein, *Federal Securities Law Coverage of Note Transactions: The Antifraud Provisions*, 35 BUS. LAW. 1567 (1980); Note, *Discretionary Commodity Accounts as "Securities": Applying the Howey Investment Contract Test to a New Investment Medium*, 67 GEO. L.J. 269 (1978); Note, *Discretionary Trading Accounts in Commodity Futures Are Not Securities Absent Horizontal Commonality*, 60 WASH. U. L.Q. 675 (1982); Casenote, *The Definition of Security:* Marine Bank v. Weaver, 24 B.C.L. REV. 1053 (1983); Comment, *The Federal Definition of a Security—An Examination of the "Investment Contract" Concept and the Propriety of a Risk Capital Analysis Under Federal Law*, 12 TEX. TECH L. REV. 911 (1981).

103. 328 U.S. 293 (1946).

104. *Id.* at 298-99. *Howey* was based, in part, upon an earlier Supreme Court decision

citrus groves sold interests in the property to investors in order to raise capital. The sales included "land sales contracts" and "service contracts" providing, respectively, for transfer of a portion of the property to the investor upon payment of the full purchase price and for servicing of the property by the company. The service contracts gave the company full possession of the land and complete discretion to manage the property.[105]

The Supreme Court found that the transaction's "economic reality" dictated that an investment contract was present.[106] The company was "offering something more than fee simple interests in land, something different from a farm or orchard coupled with management services. They are offering an opportunity to contribute money and to share in the profits of a large citrus fruit enterprise managed and partly owned by [the company]."[107] The Court found that the transaction essentially represented a "profit-seeking" business venture.[108]

Subsequent judicial construction and SEC interpretation of this holding have determined that satisfaction of the *Howey* test depends upon the presence of four elements: (1) an investment of money; (2) this investment being made in a "common enterprise"; (3) an expectation of profits from the investment; and (4) this expectation being based upon the efforts of a third party.[109] In a further refinement of the *Howey* definition, the Supreme Court, some thirty years later in *United Housing Foundation, Inc. v. Forman,*[110] stated that a particular arrangement will constitute an

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that had addressed the "investment contract" issue in more general terms. SEC v. C.M. Joiner Leasing Corp., 320 U.S. 344 (1943). In *Joiner*, the Court had stated only that the Securities Act was desigued to reach novel, uncommon, or irregular devices that could be shown to have been "widely offered or dealt in under terms or courses of dealing which established their character in commerce as 'investment contracts.'" *Id.* at 351. The Court held that the determination of whether a security was present must be made on a case-by-case basis, turning on "what character the instrument is given in commerce by the terms of the offer, the plan of distribution, and the economic inducements held out to the prospect." *Id.* at 352-53. Not until *Howey*, however, did the Court clearly articulate the set of factors to be examined as part of this analysis.

105. 328 U.S. at 295-96.

106. *Id.* at 300-01.

107. *Id.* at 299.

108. *Id.* at 300.

109. Marine Bank v. Weaver, 455 U.S. 551 (1982); International Brotherhood of Teamsters v. Daniel, 439 U.S. 551 (1979); United Housing Found., Inc. v. Forman, 421 U.S. 837 (1975); Hirk v. Agri-Research Council, Inc., 561 F.2d 96 (7th Cir. 1977); Milnarik v. M-S Commodities, Inc., 457 F.2d 274 (7th Cir.), *cert. denied*, 409 U.S. 887 (1972); Berman v. Bache, Halsey, Stuart, Shields, Inc., 467 F. Supp. 311 (S.D. Ohio 1979).

110. 421 U.S. 837 (1975).

investment contract if individuals are prompted to invest by a "significant, realistic" expectation of "substantial" profits to be derived from the entrepreneurial or managerial efforts of others.[111] In that instance, participations in a housing complex did not constitute investment contracts because no dividend payments were made as an apportionment of profits and the inducement to purchase was the acquisition of low-cost living space, not an investment for profit.[112]

The *Howey* line of cases, although leaving other questions unresolved, has made it clear that participation in a pooled investment vehicle will raise a presumption of commonality and expectation of profits based on the efforts of others. For example, when an individual deposits a specific sum of money or securities with the knowledge and expectation that this investment will be pooled with those of other similarly situated investors and that any profits will be shared on a pro rata basis, this investment likely will be a "common enterprise," the success of which is dependent upon the efforts of a third party. The agreement between the individual investor and the broker or other investment manager ordinarily is found to constitute the "security" bringing the arrangement within the scope of the Securities Act.

Although a pooling arrangement may be sufficient to support a finding of an investment contract, it is not as clear that this finding is necessary. For example, most courts have held that an individual brokerage or discretionary trading arrangement between a customer and a broker does not constitute an "investment contract" because no common enterprise exists, although the investor clearly is dependent upon the broker's efforts.[113] The Fifth and Ninth Cir-

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111. *Id.* at 851-54.

112. *Id.*

113. Hirk v. Agri-Research Council, Inc., 561 F.2d 96 (7th Cir. 1977); Milnarik v. M-S Commodities, Inc., 457 F.2d 274 (7th Cir.), *cert. denied*, 409 U.S. 887 (1972). In *Milnarik*, the customer deposited more than $13,000 with a broker who executed a number of transactions in commodity futures contracts on behalf of the customer. The customer sought to rescind the agreement on the ground that it was a security that had not been registered pursuant to the Securities Act. Although the broker represented a number of investors, the court concluded that the profit or loss of each had no bearing on that of the others. Each contract between the customer and the broker, therefore, was held to be a separate "enterprise," and there was no joint participation in a common enterprise. In *Hirk*, the court stated that absent a commingling of the funds of a number of investors, and the allocation of profit or loss on a pro rata basis, no common enterprise can be established. In so holding, the court also rejected the plaintiff's assertion that the broker had treated the funds of all customers in a substantially identical manner, although there was no formal "pooling" of funds. These cases and similar decisions have established the doctrine of so-called "horizontal commonality." In other words, the common enterprise must exist among joint partici-

cuits, however, have held that so-called "vertical" commonality—the common enterprise between one customer and a broker managing the customer's funds on a discretionary basis—is sufficient to support a finding of an investment contract.[114]

Under such circumstances, these courts have held that "uniformity of impact of the promoter's efforts," and not a horizontal pooling of money, is the critical factor. These definitions, therefore, elevate the "dependence upon the efforts of others" criterion to principal and almost exclusive importance and clearly downgrade, if not eliminate, the significance of the "common enterprise" requirement.[115] Nevertheless, although the Supreme Court has yet to resolve definitively this split among the circuits, the weight of authority seems to favor the "horizontal" commonality approach. In any event, it is significant that the "common enterprise" analysis has resulted in the characterization of a number of investments and trading relationships as investment contracts.[116]

2. Notes and Evidences of Indebtedness

Whether an instrument constitutes a "note" or an "evidence of indebtedness" under the Securities Act is in some respects simpler, but in others more complex, than the "investment contract" analysis. On one hand, the most typical forms of notes or evidences of indebtedness—promissory notes in return for loans or real estate mortgages—almost certainly were not intended to be included within the definition of a "security." Conversely, many types of "notes"—such as those a publicly held corporation issues for the purpose of raising capital—just as clearly should be included within the securities laws' protection.

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pants in the same venture.

114. SEC v. Continental Commodities Corp., 497 F.2d 516 (5th Cir. 1974); SEC v. Koscot Interplanetary, Inc., 497 F.2d 473 (5th Cir. 1974); SEC v. Glenn W. Turner Enter., 474 F.2d 476 (9th Cir.), *cert. denied*, 414 U.S. 821 (1973). In *Turner*, the court held that a common enterprise under *Howey* could exist where "the fortunes of the investor are interwoven and dependent upon the efforts and success of those seeking the investment of third parties." 474 F.2d at 482 n.7. This so-called "vertical commonality"—the common enterprise between one investor and a broker—is significantly different from the horizontal commonality established by the majority of cases decided under *Howey*. In particular, vertical commonality requires neither the pooling of customers' funds nor the interdependence of profit or loss that *Hirk* and *Milnarik* required.

115. SEC v. Continental Commodities Corp., 497 F.2d 516, 522-23 (5th Cir. 1974).

116. *See, e.g.*, Smith v. Gross, 604 F.2d 639 (9th Cir. 1979) (earthworms); Miller v. Central Chichilla Group, Inc., 494 F.2d 414 (8th Cir. 1974) (chinchillas); Glenn-Arden Commodities, Inc. v. Costantino, 493 F.2d 1027 (2d Cir. 1974) (whiskey); SEC v. Brigadoon Scotch Distrib., Ltd., 388 F. Supp. 1288 (S.D.N.Y. 1975) (rare coin collections).

In determining the Securities Act's application to the various types of notes, therefore, courts generally have distinguished between notes sold or acquired for "commercial" purposes and those purchased or acquired for "investment" reasons.[117] On this basis, a majority of the circuit courts that have addressed the issues have held that notes will be deemed to be of an "investment" character, and therefore subject to the Securities Act, if: (1) the assets acquired in exchange for the notes are of the character of "investment assets"; (2) the issuance, purchase, and sale of notes are made by persons not normally in the business of entering into the underlying type of transaction; and (3) the note creates a long-term indebtedness.[118]

Several circuits have applied variations of the investment or commercial purpose test that emphasize certain of these characteristics over others; other circuits have applied altogether different criteria. For example, the Seventh Circuit has accepted the investment or commercial purpose approach, but uses a "motivational" test in applying it.[119] This analysis focuses on the note purchaser's reasons for entering into the transaction. If the purchaser intends the note to operate as an investment, rather than as part of a commercial transaction that the purchaser entered into primarily for nonspeculative reasons, the note is likely to be regarded as a security.[120]

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117. SEC v. Diversified Indus., 465 F. Supp. 104 (D.D.C. 1979). For a general discussion of the status of notes and other evidences of indebtedness as securities, see generally Lipton & Katz, *supra* note 102; Note, *The Economic Realities of Defining Notes as Securities Under the Securities Act of 1933 and the Securities Exchange Act of 1934*, 34 U. FLA. L. REV. 400 (1982); Comment, *Commercial Notes and Definition of "Security" Under Securities Exchange Act of 1934: A Note is a Note is a Note?*, 52 NEB. L. REV. 478 (1973); Comment, *The Status of the Promissory Note Under the Federal Securities Laws*, 1975 ARIZ. ST. L.J. 175. As in other areas of the securities laws in which courts have been called upon to determine whether a given instrument constitutes a security, the focus has been on the context of the transaction rather tban the labels or descriptions the parties apply. *See* Tcherepnin v. Knight, 389 U.S. 332 (1967). In *Tcherepnin* the Supreme Court stated that, given the broad remedial purposes of the securities laws, whether a security is present should be determined on the basis of the "economic realities" of the circumstances rather than the labels provided to particular instruments or other factors.

118. Bellah v. First Nat'l Bank, 495 F.2d 1109 (5th Cir. 1974); McClure v. First Nat'l Bank, 497 F.2d 490 (5th Cir. 1974), *cert. denied*, 420 U.S. 930 (1975); SEC v. Diversified Industries, 465 F. Supp. 104 (D.D.C. 1979).

119. Sanders v. John Nuveen & Co., 463 F.2d 1075 (7th Cir.), *cert. denied*, 409 U.S. 1009 (1972); C.N.S. Enter. v. G. & G. Enter., 508 F.2d 1354 (7th Cir.), *cert. denied*, 423 U.S. 825 (1975).

120. *Sanders*, 463 F.2d at 1080; *C.N.S. Enter.*, 508 F.2d at 1356-62. In *Sanders*, short-term notes were found to constitute securities, because the note purchasers had bought the notes for investment purposes. In contrast, in *C.N.S. Enter.*, the court found that notes

In contrast, the Ninth Circuit has applied a "risk capital" test in determining whether a note is a security.[121] The issue under this approach, which in some respects parallels the investment contract characterization, is whether the purchaser of the note, or lender, has "contributed risk capital subject to the 'entrepreneurial or managerial efforts' of [others]."[122] In employing this test, the Ninth Circuit has looked at six factors: (1) the period of time the investment covers; (2) collateralization; (3) the obligation's form; (4) the circumstances of issuance; (5) the relationship between the amount borrowed and the size of the borrower's business; and (6) the borrower's contemplated use of the funds.[123]

The Second Circuit, however, adopting by far the broadest and most sweeping definition of a "note" or "evidence of indebtedness," takes a literal approach to the issue. The court has held that any note which has a maturity date exceeding nine months and is not ordinarily delivered in connection with commercial transactions (consumer financing, notes secured by mortgages on homes, short-term notes secured by liens on businesses, or assignments of accounts receivable), is presumed to be a security.[124] Again, as has been the case with the investment contract analysis, the Supreme Court has not resolved this issue definitively.

3. Options or Rights to Purchase or Sell Securities

As noted above, the Securities Act definition of a "security" also includes "any put, call, straddle, option, or privilege on any security, certificate of deposit, or group or index of securities

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executed in connection with the obligor's financing of a business purchase were not securities, because of the intended use of the funds and the nature of the transaction. It should be noted tbat the motivational test is similar to the commercial or investment purpose test, although the latter arguably looks at additional factors.

121. United Cal. Bank v. THC Fin. Corp., 557 F.2d 1351 (9th Cir. 1977); Great Western Bank & Trust v. Kotz, 532 F.2d 1252 (9th Cir. 1976).

122. *Kotz*, 532 F.2d at 1257, *United California Bank*, 557 F.2d at 1358. A principal element in making this determination, therefore, may be the relationship between the parties, i.e. whether one party is placing its funds at risk for management by the other party. In this respect, the "risk capital" test is similar to the investment contract analysis. *See supra* notes 103-16 and accompanying text.

123. *United Cal. Bank*, 557 F.2d at 1358.

124. Excbange Nat'l Bank v. Touche Ross & Co., 544 F.2d 1126 (2d Cir. 1976); Movielab, Inc. v. Berkey Photo, Inc., 452 F.2d 662 (2d Cir. 1971). In *Exchange Nat'l Bank*, Judge Friendly noted that the standards of the Fifth, Seventh and Ninth Circuits described above failed to provide sufficient certainty in making the necessary determination. As a result, Judge Friendly held that when a note is encompassed under the definition of a security as a prima facie matter, the party attempting to demonstrate that the note is not a security has the burden of proof. *See* Note, *supra* note 117, at 416-18.

(including any interest therein or based upon the value thereof), or any put, call, straddle, option, or privilege entered into on a national securities exchange relating to foreign currency, . . . or warrant or right to subscribe to or purchase" a security.[125] Congress added this provision to the Securities Act in 1982, partially in response to the proliferation of new financial instruments reaching the market at that time and as a result of the Shad-Johnson Accord, which delineated jurisdiction over these products between the SEC and the CFTC.[126]

Briefly stated, the CEA, as discussed more fully below, provides the CFTC with exclusive jurisdiction over futures contracts (and options on futures contracts) on any commodity, including foreign currencies and securities.[127] By the late 1970s and early 1980s, it was not clear whether, or to what extent, the CFTC had jurisdiction over options directly on financial instruments.[128] In an attempt to resolve this issue, the chairmen of the CFTC and SEC reached an agreement in 1981, designated the Shad-Johnson Accord, which subsequently was submitted to Congress in the form of appropriate amendments to the securities laws and the CEA.[129]

The Shad-Johnson Accord granted the CFTC exclusive jurisdiction over futures contracts and options on futures contracts on any commodity, including securities and foreign currencies, as well as currency indexes.[130] The CFTC was expressly prohibited, however, from approving the trading of any futures contracts or futures options on individual securities other than those issued by the United States government.[131] The CFTC also received exclusive jurisdiction over options on foreign currencies not traded on a national securities exchange.[132] Conversely, the SEC was granted exclusive jurisdiction over options directly on securities, including exempted securities and indexes of securities, as well as options on

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125. 15 U.S.C. § 77b(1) (1982).

126. *See* Joint Explanatory Statement of the Securities and Exchange Commission and the Commodity Futures Trading Commission, *reprinted in* [1980-1982 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 21,332 (Feb. 2, 1982); Markham & Gilberg, *supra* note 41, at 777-79.

127. 7 U.S.C. § 2 (1982 & Supp. III 1985). *See also* Johnson, *supra* note 17, at 61; Note, *supra* note 17, at 710.

128. *See* Markham & Gilberg, *supra* note 41, at 772-76.

129. H.R. REP. No. 626, 97th Cong., 2d Sess. (1982); S. REP. No. 390, 97th Cong., 2d Sess. (1982); Act of October 13, 1982, Pub. L. No. 97-303, 96 Stat. 1409.

130. Act of October 13, 1982, Pub. L. No. 97-303, 96 Stat. 1409.

131. *Id.*

132. *Id.*

foreign currency traded on a national securities exchange.[133]

As a result of these amendments, options on individual securities, as well as options on indexes of securities, clearly constitute separate securities, and they are subject to the registration provisions of the Securities Act, absent an appropriate exemption. Moreover, an exemption will not necessarily be available simply because the security underlying the option itself is exempt from registration.[134] Thus, for example, an option on a municipal security or a United States Treasury Bond presumptively is subject to registration, regardless of the underlying instrument's exempt status. In addition, an option on an index of such securities similarly is subject to Securities Act registration. As a result, such products may be lawfully offered and sold only pursuant to an effective registration statement filed under the Securities Act or through an exemption from registration.

4. Exemptions to Securities Act Registration

The Securities Act establishes a number of exemptions from securities registrations. First, "exempt securities," principally comprised of United States government securities and municipal bonds, need not be registered.[135] In this regard, it should be noted that securities which a bank issues or guarantees also are exempt securities and may be offered and sold without registration.[136] These include a bank's own securities or another issuer's securities that are backed by a bank guarantee or letter of credit. Furthermore, short-term commercial paper may be offered and sold without Securities Act registration.[137]

One of the exemptions from registration most often relied

133. *Id.*

134. *See, e.g.*, LTV Federal Credit Union v. UMIC Government Securities, Inc., [1982-1983 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 99,193 (5th Cir. 1983).

135. 15 U.S.C. § 77c(a)(2) (1982). An exempt security, of course, is one that falls within the definition of a "security" but need not be registered, based upon a legislative determination that purchasers of such instruments are not in need of the protections Securities Act registration affords. Nevertheless, because such instruments are securities, certain of the remaining provisions of the securities laws—in particular, the anti-fraud sections—remain applicable to their offer and sale.

136. *Id.* In order to be entitled to this exemption from registration, the bank must back the security in full, pursuant to a guarantee or some other type of general obligation, such as a letter of credit. *See, e.g.*, American Bankers Club, Inc., SEC No-Action Letter, [1979-1980 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 82,382 (August 31, 1979) (Securities are not "issued or guaranteed" by bank when there is no obligation directly enforceable against the bank).

137. 15 U.S.C. § 77c(a)(3) (1982).

upon, however, is the so-called "private placement" or "private offering" exemption established under section 4(2) of the Securities Act.[138] That provision states that the registration requirement does not apply to sales of securities "not involving any public offering" and is intended primarily to encompass privately negotiated transactions among related parties.[139] The securities laws, however, long have reflected an understanding that certain investors, by virtue of their expertise, sophistication, or wealth, do not require the protections provided under these statutes and should be permitted to purchase securities regardless of their registration status.[140] This approach has found its clearest expression in the interpretation of section 4(2) of the Securities Act, which has been construed to permit sales of unregistered securities to "accredited investors," subject to a number of conditions.[141]

Moreover, in 1982 the SEC adopted a safe harbor rule, known as "Regulation D," which clarified and expanded small offering and private placement exemptions previously contained in SEC

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138. *Id.* § 77d(2) (1982).

139. *Id.*

140. *See, e.g.*, SEC v. Murphy, 626 F.2d 633 (9th Cir. 1980); SEC v. Continental Tobacco Co., 463 F.2d 137 (5th Cir. 1972); SEC v. Ralston Purina Co., 346 U.S. 119 (1953). *See also, e.g.*, SEC Rel. No. 33-6274 (Dec. 23, 1980) (regarding "institutional-type" individuals "with sufficient experience, expertise, and financial clout to protect their own interests [who] do not need the SEC to obtain adequate information about a company in which tbey invest—they can get this information themselves"). *See also* SEC Rel. No. 33-6180 (Jan. 17, 1980); SEC Rel. No. 6121 (Sept. 11, 1979); SEC Rel. No. 6121 (Sept. 11, 1979); *Hearings Before the Subcommittee on Securities of the Senate Committee on Banking, Housing and Urban Affairs*, 96th Cong., 2d Sess. 5 (1980).

Recently, the SEC has determined that the Investment Advisers Act of 1940 prohibitions against an investment adviser's imposition of a performance or incentive fee should not apply in all instances to advisory contracts with:

> persons who, because of their wealth and financial knowledge and experience, [are] considered to be less dependent on the protections which the performance fee prohibition is intended to provide . . . . The [SEC] has concluded that it is consistent witb the protection of investors and the purposes of the [Investment Advisers] Act to permit clients who are financially experienced and able to bear tbe risks associated with performance fees to have the opportunity to negotiate compensation arrangements which they and their advisers consider appropriate.

SEC Rel. No. IA-996 (Nov. 14, 1985).

141. *See* Ketels, *Regulation D—The New Regulatory World for Limited Offerings*, 5 CORP. L. REV. 268 (1982); Newman & Goldenberg, *Venture Capital Formation Under the SEC's New Regulation D*, Nat'l. L. J., July 5, 1982, at 16. Section 2(15) of the Securities Act defines the term "accredited investor" to include certain large institutional investors, such as banks, insurance companies, registered investment companies, business development companies and certain employee benefit plans. 15 U.S.C. § 77b(15) (1982). In addition, section 2(15) authorizes the SEC to promulgate regulations to broaden the definition to include any other persons who, in its view, are sufficiently sophisticated, knowledgeable, and experienced in financial matters so as not to need the protection that registration affords. *Id.*

rules.[142] Regulation D is comprised of six separate regulations promulgated under the Securities Act. Offerings that comply with the regulation will be presumed not to be "public offerings," rendering them exempt from registration.[143]

The most significant aspect of Regulation D is the definition of the term "accredited investor," which includes not only traditional institutional investors but also a large number of individuals.[144] In particular, the rule encompasses sales of unregistered securities to individuals who (1) have a net worth in excess of 1,000,000 dollars; (2) have annual incomes of greater than 200,000 dollars; or (3) purchase at least 150,000 dollars of the investment at issue, but only if such investment does not exceed twenty percent of the purchaser's net worth.[145] The substantive provisions of Regulation D allow three separate types of offerings to be made, based upon the amount of the offering. First, offerings of up to 500,000 dollars may be made regardless of the purchasers' status and in the absence of any specific disclosure.[146] Second, offerings of up to 5,000,000 dollars may be made to an unlimited number of accredited investors and up to thirty-five nonaccredited investors.[147] With respect to nonaccredited investors, Regulation D imposes no sophistication or other qualification tests. Finally, under the actual safe harbor portion of the rule, an unlimited dollar amount of securities may be *offered* to any number of persons.[148] *Sales*, however, only may be made to thirty-five nonaccredited but "qualified" purchasers and to an unlimited number of accredited investors.[149]

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142. 17 C.F.R. § 230.501-.506 (1986); SEC Rel. No. 33-6389 (Mar. 8, 1982).

143. 17 C.F.R. § 230.501-.506 (1986); SEC Rel No. 33-6389 (Mar. 8, 1982). Regulation D replaced a series of SEC regulations promulgated under section 4(2) of the Securities Act that previously had constituted the "safe harhor" for private offerings. Regulation D, however, is substantially broader than these prior regulations. *See, e.g.*, Casey, *SEC Rules 144 and 146 Revisited*, 43 BROOKLYN L. REV. 571 (1977); Marsh, *Who Killed the Private Offering Exemption?*, 71 NW. U. L. REV. 470 (1976); Schneider, *Section 4(2) and Statutory Law*, 31 BUS. LAW 485 (1975).

144. 17 C.F.R. § 230.501(a) (1986). With respect to institutions, the definition encompasses banks, insurance companies, registered investment companies, small business development companies, private husiness development companies, and organizations with more than $5,000,000 in assets covered by section 501(c)(3) of the Internal Revenue Code.

145. That definition also includes the issuer's directors, executive officers, and general partners.

146. 17 C.F.R. § 230.504 (1986).

147. *Id.* § 230.505.

148. *Id.* § 230.506.

149. *Id.* Qualification for the non-accredited investors need not be determined prior to the making of an offer, but it must be completed before consummation of the sale. With

Regulation D is of major significance not only to corporate issuers, but, as discussed below, also to institutions offering financial products that arguably could be characterized as securities. On the basis of this series of regulations, such an institution ordinarily can be assured that it may offer a particular type of instrument under the securities laws provided that it is willing to restrict the manner in which offers and sales are made and the scope of permissible offerees. Moreover, because most of the securities-type instruments developed and offered today are directed toward institutional market participants, this latter constraint in practice may not alter substantially an issuer's proposal. In many instances, therefore, Regulation D provides a viable alternative to Securities Act registration.

B. *The Investment Company Act of 1940*

Another of the principal federal securities statutes is the Investment Company Act of 1940 (ICA), which regulates the activities of mutual funds and other vehicles for pooled investments in securities.[150] Although the mutual fund industry, which is the principal focus of the ICA, is beyond the scope of this Article, the ICA nevertheless has direct relevance to the offer and sale of many recently developed financial products because of the possible inclusion of such instruments within the ICA's definition of an "investment company." In particular, many products or trading arrangements may fall within the so-called "inadvertant investment company" rubric, thereby invoking the ICA's terms. Such a result would have a dramatic adverse effect on any institution's ability to offer such a product, because the ICA imposes an extensive and often extremely burdensome set of regulations covering virtually

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respect to the "safe harbor," and the permissibility of offerings of up to five million dollars, offerees must receive specific types of disclosure regarding tbe issuer and the security. Moreover, in contrast to the *de minimus* exemption for offerings of up to $500,000, tbe latter two exemptions prohibit any general advertising or solicitation. As a result, offerors seeking to avail themselves of the safe harbour may communicate with potential purchasers only through direct and individual contacts, or through private negotiations, although there need not have been a pre-existing investment relationship between the parties. *See, e.g.*, Woodtrails-Seattle Ltd., SEC No-Action Letter (Aug. 2, 1982); Mineral Lands Research & Marketing Corp., SEC No-Action Letter (Dec. 4, 1985).

150. 15 U.S.C. §§ 80a-1 to 80a-64 (1982). The ICA perhaps is the most complex and extensive of all the federal securities statutes; it establishes a detailed set of requirements for entities subject to its jurisdiction. Such entities must adopt a corporate structure according to a specific form, and must comply continuously with numerous reporting, recordkeeping, voting, proxy, disclosure, and other requirements. *See* T. FRANKEL, THE REGULATION OF MONEY MANAGERS 199-203 (1978); L. LOSS, *supra* note 87, at 144-53.

every aspect of the issuer's business, such as records, reports, and board of directors' management.[151]

Tbe ICA establishes two alternative tests for determining whether a given entity constitutes an investment company. The first is a more subjective test that defines an investment company as any issuer that "is or holds itself out as being engaged primarily, or proposes to engage primarily, in the business of investing, reinvesting, or trading in securities."[152] This definition is intended to encompass the more conventional type of investment company, which is in the business of investing in securities and holds itself out as such. The test, therefore, describes a set of activities that in many, if not most, instances will be readily identifiable, although determining investment company status under this approach requires consideration of an entity's total activities. In addition, the entity actually must be trading or investing in securities and not merely holding them.[153] Furthermore, the "holding out" element establishes a solicitation aspect that might exclude a number of entities presumptively within the scope of the statute.[154]

The principal issue under this test, however, is the "primarily engaged" criterion. The SEC has stated that this issue should be resolved through an analysis of a number of factors, including the entity's investment history; its representations to the public; its officers' and directors' activities; the nature of its assets; and the source of its income.[155] If, for example, an entity has traded extensively in securities and derived a substantial amount of its income from securities, those factors may create a presumption of investment company status.

Conversely, the second approach under the ICA involves a more objective analysis designed to capture the "inadvertant investment company," which often is an issuer that does not purport or intend to be characterized as an investment company but essentially operates as an investment company because a large portion

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151. 15 U.S.C. §§ 80a-1 to 80a-64 (1982).

152. *Id.* § 80a-3(a)(1).

153. *See* SEC v. Fifth Avenue Coach Lines, Inc., 289 F. Supp. 3, 27 (S.D.N.Y. 1968), *aff'd*, 435 F.2d 510 (2d Cir. 1970).

154. Committee on Commodities Reg., Bar Ass'n City of New York, *'40 Acts' Applicability to Commodity Pools and Trading Advisors*, 37 Bar Ass'n Rec. 611, 632 (1982).

155. Moses v. Black [1981 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 97,866 (S.D.N.Y. 1981); Tonopah Mining Co. of Nevada, 26 S.E.C. 426, 427 (1947), *citing*, Bankers Securities Corp., 15 S.E.C. 695, *aff'd sub nom.* Bankers Securities Corp. v. SEC, 146 F.2d 88 (3d Cir. 1944); T. FRANKEL, *supra* note 150, at 221-24; Kerr, *The Inadvertent Investment Company: Section 3(a)(3) of the Investment Company Act*, 12 STAN. L. REV. 29 (1959).

of its assets are invested in securities.[156] This provision defines an "investment company" as an issuer that "is engaged or proposes to engage in the business of investing, reinvesting, owning, holding, or trading in securities, and owns or proposes to acquire investment securities having a value exceeding 40 per centum of the value of such issuer's total assets (exclusive of Government securities and cash items) on an unconsolidated basis."[157]

This definition contains a number of significant distinctions from the subjective test set forth above. First, there is no requirement that the entity be "primarily engaged" in the business of investing or trading in securities. To the contrary, "holding" or "owning" securities may be sufficient provided that the entity meets the asset test. Second, the entity may be characterized as an investment company when the value of the securities it holds reaches forty percent of its assets. This element can be extremely troublesome for many entities with large securities portfolios, because an increase in a portfolio's value resulting from market fluctuations, if the entity's other assets do not similarly increase in value, could increase the portion of the entity's assets invested in securities to the forty percent level, thereby triggering the ICA requirements. Moreover, the statute becomes applicable if this objective test is met at any time, even if the percentage of the entity's assets invested in securities subsequently falls below forty percent.[158]

Nevertheless, the SEC has promulgated rules that would prevent an entity from being characterized as an investment company even if it presumptively is within the statute by virtue of the asset test.[159] The first regulation provides that an entity meeting this test will not be deemed an investment company if securities constitute no more than forty-five percent of its total asset value and amount to no more than forty-five percent of its net income after

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156. 15 U.S.C. § 80a-3(a)(3) (1982); *see also* Kerr, *supra* note 155. The problem of the inadvertent investment company is one of extreme importance for entities developing and offering new financial instruments. If a particular product results in the entity itself, or a "pool" established by the entity, being deemed an investment company, a dramatic restructuring of the operation will be required; in fact, it is more likely that such a result simply will force the offeror to abandon its program. Moreover, by definition, the "inadvertent" problem could arise simply as a result of fluctuations in the value of an entity's assets, without any conscious or deliberate action on its part.

157. 15 U.S.C. § 80a-3(a)(3) (1982).

158. Committee on Commodities Reg., *supra* note 154, at 630.

159. 17 C.F.R. §§ 270.3a-1—.3a-2 (1986).

taxes.[160] By allowing forty-five percent of the entity's asset value to be invested in securities, as opposed to forty percent under the statute, the SEC rule provides some additional flexibility.

In a second rule, the SEC has stated that an entity will not be deemed an investment company during a period of time of up to one year, provided it has a bona fide intent to engage, as soon as is reasonably practicable, in a business other than securities investment.[161] Finally, the ICA exempts an entity whose outstanding securities (other than short-term paper) are beneficially owned by not more than one hundred persons and that is not making and does not propose to make a public offering of its securities.[162] This exemption is qualified, however, by the requirement that the computation of the number of holders include the securities holders of any entity holding more than ten percent of the presumptive investment company's voting securities, if such equity ownership represents more than ten percent of the entity's asset value.[163]

IV. SEC-CFTC Jurisdictional Conflicts

The futures industry originally centered exclusively on futures and option contracts on agricultural commodities.[164] Indeed, so-called financial futures did not even exist until the early 1970s.[165] As a result, at the time of its formation, the CFTC primarily was intended to regulate trading in agricultural futures and options. In addition, Congress concluded that the nature of a futures contract was distinct from a security and that CFTC jurisdiction should be delineated on the basis of this distinction.[166]

As a result, the 1974 amendments to the CEA, which created the CFTC, granted the CFTC exclusive jurisdiction over all trans-

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160. *Id.* § 270.3a-1.

161. *Id.* § 270.3a-2. The one year period commences when the value of an entity's cash or securities exceeds fifty per cent of its total asset value, or when the value of its investment securities exceeds forty percent of its total asset value. *Id.* At the conclusion of the one year period, however, the entity once again is subject to the possibility of ICA registration.

162. 15 U.S.C.] 8a-]3(c)(1) (1982).

163. *Id.*

164. *See supra* notes 14-15 and accompanying text; *see also* Markham & Gilberg, *supra* note 41, at 769.

165. Fitzgerald, *Innovations in Financial Futures*, BANKER, April 1983, at 95; Markham & Gilberg, *supra* note 3, at 1721; Yeutter, *supra* note 15, at 64-66.

166. *See* Johnson, *supra* note 17, at 61; *Reauthorization of the Commodity Futures Trading Commission: Hearings Before the Subcommittee on Agricultural Research and General Legislation of the Senate Committee on Agriculture, Nutrition and Forestry*, 95th Cong., 2d Sess. 171-72 (1978) (Statement of Robert K. Wilmouth, President of the Chicago Board of Trade) [hereinafter Reauthorization Hearings].

actions in futures contracts and options on physical commodities.[167] In addition, as noted, Congress in 1974 significantly expanded the definition of "commodity" for the purposes of CFTC jurisdiction, thereby broadening its scope to cover foreign currencies, certain securities, and a wide variety of other types of instruments.[168]

Nevertheless, in an attempt to limit whatever encroachment on SEC jurisdiction might have resulted, Congress included a provision in the CEA stating that "nothing contained in this section shall . . . supersede or limit the jurisdiction . . . conferred on the Securities and Exchange Commission."[169] This savings clause was designed to assure continued SEC jurisdiction over transactions in securities, notwithstanding the CFTC's exclusive control over futures trading in all commodities, including futures contracts on securities.[170] This attempt, however, was doomed virtually from the start. First, as noted above, the federal securities laws define a "security" to include any right or contract to purchase a security.[171] This definition unquestionably encompasses any futures or options contract on a security or group of securities. By the very terms of the relevant statutes, therefore, the jurisdictional issue had not been resolved.

Moreover, the explosion in the financial futures markets began almost immediately after the formation of the CFTC. In 1975 the CFTC granted the Chicago Board of Trade's (CBT's) application for designation as a contract market in the trading of futures contracts on GNMA certificates.[172] Shortly thereafter, the Chicago Board of Trade and a number of other commodity exchanges be-

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167. Pub. L. No. 93-463, 88 Stat. 1389, 1395 (1974); Johnson, *supra* note 17, at § 1.01.

168. S. REP. No. 1131, 93d Cong., 2d Sess. (1974); *Commodity Futures Trading Commission Act of 1974: Hearings on H.R. 11955 Before the House Committee on Agriculture*, 93d Cong., 2d Sess. (1974).

169. 7 U.S.C. § 2 (1982 & Supp. III 1985); Pub. L. No. 93-463, 88th Stat. 1389, 1395 §a 201(b) (1974). *See also* Securities Exchange Commission—Commodity Futures Trading Commission Jurisdictional Correspondence, *compiled at* [1975-1977 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 20,117 [hereinafter cited as SEC-CFTC Jurisdictional Correspondence]; SEC v. Univest, [1975-1977 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 20,116 (N.D. Ill. 1975); SEC v. Norton, Inc., [1975-1977 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 20,204 (N.D. Ill. 1976); Guttman, *The Futures Trading Act of 1978: The Reaffirmation of CFTC-SEC Coordinated Jurisdiction over Security/Commodities*, 28 AM. U. L. REV. 1 (1978).

170. 7 U.S.C. § 2 (1982 & Supp. III 1985). Nevertheless, the "savings" clause stated that SEC jurisdiction over transactions in securities was to he maintained only where such transactions do not involve the purchase or sale of securities futures contracts. *Id.*

171. 15 U.S.C. § 77b(1) (1982); *see supra* notes 125-34 and accompanying text.

172. SEC-CFTC Jurisdictional Correspondence, *supra* note 169, at 20,831.

gan trading futures contracts on a broad range of financial instruments, such as United States Treasury bonds and Treasury bills.[173] This action precipitated a sharp dispute between the CFTC and the SEC that was heightened further, as discussed below, five years later by the SEC's decision to allow options trading on the same instruments.[174]

In a 1975 letter to the CFTC, SEC Chairman Roderick Hills stated that "GNMA certificates and Treasury bills are securities, as that term is defined in the federal securities laws. We also believe it to be quite clear that contracts for future delivery of those securities are also 'securities.' "[175] The letter urged greater SEC and CFTC cooperation in defining each agency's jurisdictional boundaries, and it requested that the CFTC refrain from any further authorization of trading in securities futures.[176]

In response to this letter, the CFTC's Office of General Counsel prepared and issued a lengthy memorandum, which detailed the bases of the CFTC's exclusive jurisdiction and attempted to refute the SEC's assertion of jurisdiction over GNMA futures.[177] The memorandum concluded that Congress had vested in the SEC authority over securities and options on securities, but had granted exclusive regulatory control over commodity options and all futures contracts, including those on securities, to the CFTC.[178]

In Congress' 1978 reauthorization of the CFTC, the SEC and the Chicago Board Options Exchange (CBOE) again stressed the similarity between futures contracts and options on securities, arguing that because the two are functionally indistinguishable and because the SEC has jurisdiction over the latter, the SEC also should have jurisdiction over the former.[179] The CFTC and the

173. CFTC Release No. 92-75 (Nov. 26, 1975); CFTC Release No. 323-77 (Aug. 2, 1977).

174. SEC-CFTC Jurisdictional Correspondence, *supra* note 169, at 20,831.

175. *Id.* at 20,829.

176. *Id.* at 20,829-31.

177. *Id.* at 20,831-41.

178. *Id.* at 20,831-33, *citing* S. REP. No. 1131, 93d Cong., 2d Sess. 31 (1974).

179. *Extend Commodity Exchange Act: Hearings on* H.R. 10,285 *Before the House Subcommittee on Conservation and Credit of the House Committee on Agriculture*, 95th Cong., 2d Sess. 182-219 (1978) [hereinafter cited as 1978 House Hearings]. The principal spokesmen for the SEC position in the 1978 hearings were Harold M. Williams, Chairman of the SEC, and Joseph W. Sullivan, President of the CBOE. Williams argued that futures on securities inevitably affect the market in the underlying securities because the commodities and securities markets are interrelated: "And yet, there is confusion regarding the extent to which persons trading these securities in the form of futures contracts are regulated by the [Securities and Exchange] Commission and the extent to which persons purchasing such securities may rely upon the protections of the federal securities laws." *Id.* at 782. The

commodities exchanges, however, continued to maintain that a futures contract, as an instrument, is functionally distinct from a security and should not be regulated as a security.[180] To complicate matters even further, both the Treasury and the General Accounting Office (GAO) submitted proposals to Congress in 1978. The Treasury argued that it should have at least some authority over futures contracts on government securities, and the GAO supported the SEC's position.[181] Nevertheless, Congress retained the CFTC's exclusive jurisdiction. Congress, however, did enact a provision requiring the CFTC to "maintain communications" with the SEC, the Treasury Department, and the Federal Reserve Board in areas of overlapping concern and to "take into consideration" these agencies' views in approving applications for trading in futures on government securities.[182]

This resolution, however, did little, if anything, to alleviate the conflict. New escalation began in 1981 when the CBOE applied to the SEC for permission to trade options on GNMA certificates.[183] The SEC approved the application and concluded that it had exclusive jurisdiction over any options on securities traded on a

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SEC's interest in the securities underlying these futures contracts and its significantly more extensive experience in options trading, Williams argued, warranted SEC regulation of their trading. *Id.* at 189-91. Sullivan stated that "because the SEC has historically regulated securities and securities markets in general, it is appropriate and necessary that the SEC's jurisdiction extend to futures contracts and options with respect to securities." *Id.* at 216. He advocated the redrafting of the CFTC's jurisdictional role, which would grant the CFTC exclusive jurisdiction only over futures trading on traditional commodities. *Id.* at 218-19.

Significantly, the CBOE was created in order to provide a futures-type market for the trading of options on securities. *See* ROBERT R. NATHAN ASSOC., INC., PUBLIC POLICY ASPECTS OF A FUTURES-TYPE MARKET IN OPTIONS ON SECURITIES (1969); Board of Trade v. SEC, 677 F.2d 1137, 1140 n.2 (7th Cir.), *vacated as moot*, 459 U.S. 1026 (1982). Prior to the CBOE's creation, options on securities only had been tradeable privately or in the over-the-counter market. *See* Markham & Gilberg, *supra* note 41, at 742-46. The SEC regulates the CBOE as a national securities exchange, and the CBOE operates in the same manner as other national securities exchanges trading options. Nevertheless, based upon its purpose and origins, the CBOE retains many of the features of a commodities exchange. *Id.*

180. Reauthorization Hearings, *supra* note 166, at 171-72 (statement of Robert K. Wilmouth). Mr. Wilmouth, President of the Chicago Board of Trade, testified tbat an allocation of jurisdiction along the lines suggested by Williams and Sullivan would not be feasible, because futures contracts, either on commodities or financial instruments, are distinct from any form of security and constitute a functionally separate type of trading vehicle.

181. H.R. REP. No. 1181, 95th Cong., 2d Sess. 13, 33-34 (1978); H.R. CONF. REP. No. 1628, 95th Cong., 2d Sess. 17 (1978).

182. Pub. L. No. 95-405, 92 Stat. 865 (1978). *See* H.R. REP. No. 1181, 95th Cong., 2d Sess. 45-46 (1978).

183. SEC Rel. No. 34-17,577 (Feb. 26, 1981); SEC Rel. No. 34-16,801 (May 12, 1980). *See also Report of the Joint Treasury-SEC-Federal Reserve Board Study of the Government Related Securities Markets*, 96th Cong., 2d Sess. (Comm. Print 1980).

national securities exchange.[184] Immediately thereafter, the CBT challenged the SEC's action in the Seventh Circuit. The CBT argued that a GNMA certificate is a commodity under the CEA and options on GNMA certificates are within the CFTC's exclusive jurisdiction.[185] Before the court could take any definitive action, however, the chairmen of the CFTC and the SEC entered into the Shad-Johnson Accord, which attempted to divide jurisdiction over financial instruments between the regulatory bodies.[186] Nevertheless, the Seventh Circuit noted that the Accord could have no effect until Congress enacted its provisions. Therefore, the court did not consider the Accord in rendering the decision.[187]

Instead, a divided court held that the CFTC had exclusive jurisdiction over GNMA options and that the SEC had exceeded its jurisdiction in authorizing their trading on the CBOE.[188] Noting that much of the regulatory division between options and futures was "fortuitous," the court stated that "had the plan [for exchange traded options] emerged after the 1974 Amendments to the Commodity Exchange Act, when the term 'commodity' was broadened to encompass securities and the CFTC was awarded exclusive regulatory jurisdiction, the Chicago Board of Trade could have retained its original objective of trading securities *futures contracts* on its own floor under the same statute—the Commodity Exchange Act—governing its other activities."[189]

After reviewing the legislative history, the court further concluded that Congress, in granting the CFTC exclusive jurisdiction over commodity options, intended to authorize SEC jurisdiction

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184. SEC Rel. No. 34-17,577 (Feb. 26, 1981); SEC Rel. No. 34-17,005 (July 24, 1980).

185. Board of Trade v. SEC, 677 F.2d 1137, 1146 (7th Cir.), *vacated as moot*, 459 U.S. 1026 (1982).

186. *Joint Explanatory Statement of the Securities and Exchange Commission and the Commodity Futures Trading Commission, reprinted in* [1980-1982 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 21,332 (Feb. 2, 1982) [hereinafter Sbad-Johnson Accords].

187. 677 F.2d 1137, 1142 n.8 (7th Cir.), *vacated as moot*, 459 U.S. 1026 (1982).

188. *Id.* at 1144-54.

189. *Id.* at 1140 n.2 (emphasis original). The CBT noted in its brief that the CBOE's president had testified before Congress that the "economic similarities between options and futures, and their relationship to underlying securities are well known to market economists . . . . Suffice it to say that because of the economic characteristics that options and futures have in common, there are many circumstances when both options and futures may be used for the same purpose." 1978 House Hearings, *supra* note 179, at 217. In addition, the CBT quoted SEC Cbairman Williams' 1978 statement that "despite the technical differences between futures on securities and options on securities, in a pragmatic vein the two investment vehicles are distinctly similar. At the most basic level, the prices of both futures on securities and options on securities are primarily dependent on the same factor—the price of the underlying security." *Id.* at 194-95.

only over options on equity securities or corporate debt instruments.[190] Subsequently, Congress enacted the Shad-Johnson Accord through appropriate amendments to the CEA and the federal securities statutes.[191] These statutory amendments broadly define the CFTC's exclusive jurisdiction as extending to all futures contracts and options on futures contracts, regardless of the underlying commodity or instrument, while the SEC retains exclusive jurisdiction over options on individual securities.[192] In particular, the CFTC retains exclusive jurisdiction over futures contracts on individual government securities or on indices of stocks and municipal bonds and over options on such futures contracts.[193] The CFTC may not approve trading in futures contracts on individual equity or municipal securities.[194] In contrast, the SEC retains exclusive jurisdiction over all options on securities, including exempt securities and exempt securities indices.[195] With respect to options on foreign currencies, the SEC has jurisdiction when those instruments are traded on a national securities exchange. The CFTC has jurisdiction in all other instances.[196] Currency options, therefore, represent the only instance to date when jurisdiction is determined by the forum in which the instrument is traded.

V. Applicability of the Federal Securities and Commodities Laws to New Financial Instruments

A. *Interest Rate Products*

Many of the new financial products available today developed as a result of the dramatically increased interest rate and foreign

190. 677 F.2d at 1159-60.

191. Pub. L. No. 97-303, 96 Stat. 1409 (1982); *See* H.R. 5447, 97th Cong., 2d Sess. (1982); 128 Cong. Rec. S. 14,813 (daily ed. Dec. 15, 1982); H.R. Rep. No. 626, 97th Cong., 2d Sess. (1982); S. Rep. No. 390, 97th Cong., 2d Sess. (1982).

192. H.R. Rep. No. 626, 97th Cong., 2d Sess. (1982).

193. *Id.*

194. *Id.*

195. *Id.*

196. *Id.* It should be noted that, with its enactment into law, the Shad-Johnson Accord did not end the jurisdictional disputes between the SEC and the CFTC. In particular, shortly thereafter, a new conflict developed over the trading of so-called "sub-indexes" on groups of securities. *See What's New in Commodities—Another Way to Hedge: Sub-Indexes,* N.Y. Times, Nov. 21, 1982, at F21; *New Batch of Options Expected,* N.Y. Times, Oct. 24, 1983, at D9. After months of fierce industry battles, however, most of the sub-indexes were shelved, due either to regulatory hurdles or simple lack of market interest. *See CFTC Puts Four CME Sub-Indexes on Hold After SEC Complains,* Fin. Futures, Jan. 10,1983, at 8; *Equity, Commodity Options Execs Clash Over New Product Regulation,* Fin. Futures, Mar. 14, 1983, at 9.

currency risk incurred by most corporations, and even some individuals, doing business internationally. With the rapid fluctuations in interest and foreign exchange rates in the last decade, virtually every commercial enterprise and private investor has found itself subject to a growing variety of pressures and a parallel need to protect as much as possible against these influences. One result of this need has been the development of "swap" agreements, which allow parties to shift risks that would otherwise be experienced in commercial transactions.

Swap arrangements, in essence, constitute simultaneous forward contracts. In its simplest terms, an interest rate swap restructures debt obligations by changing the nature of interest payments from floating to fixed or fixed to floating, Libor-based to prime or prime to Libor-based.[197] Typically, two parties, one with a floating rate debt obligation and one with a fixed rate debt obligation on identical principal amounts, agree to swap interest payments on their obligations. Because it is unlikely that the two parties have obtained credit on the same terms, however, the weaker credit often pays the stronger credit a premium for the swap. In addition, the principal does not change hands. To the contrary, payments are netted out so that only a net difference flows from one party to the other.[198]

In many swap transactions one or both of the parties may be required to deposit collateral, in cash or securities, equal to the value of that entity's exposure, in order to secure its obligations to

197. *See The Incredible World of Swaps*, EUROMONEY, Nov. 1983 at 61; *Standardising Swaps Documentation*, INT'L FIN. L. REV., Mar. 1985, at 11-15; *Inside the Swaps Market*, INTERMARKET, Feb. 1986, at 27-38. Swaps developed as a result of the tremendous and unprecedented fluctuations in interest rates that began to occur in the 1970s. As a result of the availability of higher interest rates in the United States, huge amounts of capital began to flow into the United States while, at the same time, domestic corporations sought lower rate financing in the burgeoning Eurobond market. The first interest rate swaps, therefore, were just a part of the currency swaps, described below. With the growth of cheaper, floating rate financing in the early 1980s, however, the first "pure" interest rate swaps were established, prompted by the desire of floating rate obligors to obtain lower financing rates while still retaining the ability to fix the rates at some point in time. *Inside the Swaps Market*, INTERMARKET, Feb. 1986, at 28-30. Entities seeking to limit interest rate exposure could of course enter into hedging transactions in futures and option contracts, primarily on Treasury bills, notes and bonds. Nevertheless, futures contracts, as noted, are standardized, while swaps can be tailored to an institution's particular needs. In addition, futures contracts for the most part extend only about two years into the future, and trading activity is generally concentrated in the nearby months. *See The $150 Billion Baby*, BARRON'S, Aug. 19, 1985, at 15, 36-39.

198. *See supra* note 197. *See also* INTERNATIONAL SWAP DEALERS' ASSOC., CODE OF STANDARD WORDING, ASSUMPTIONS AND PROVISIONS FOR SWAPS § 9.2 (1985).

the other party.[199] As interest rates fluctuate, thereby increasing or reducing this exposure, the party depositing collateral likely will be required to provide additional collateral or will have excess collateral released to it. Most swap agreements also include liquidated damages clauses, which usually are extremely complex, that require a party seeking to close out a transaction to pay a settlement to the other party.[200] This type of provision, therefore, essentially allows liquidation of swap positions by one or both parties.

Swaps often are executed through an intermediary, rather than directly between the two principals to the arrangements. These agreements, known as "double swaps" are substantively identical to the swaps described above, except that the intermediary interposes itself between the two principals.[201] The parties may desire the intermediary for a variety of reasons. For example, the parties may be unwilling to accept the risk of nonpayment and therefore may wish to have the additional protections provided by a reputable bank or brokerage firm undertaking the other party's obligations. In addition, the availability of an intermediary substantially involved in the swap business may make it easier for a party to find a suitable and willing second party.

In double swaps, each party deals solely with the intermediary and might not even know the other party's identity.[202] The intermediary enters into a separate agreement with each borrower that, in effect, guarantees the receipt of the swap payment due from the other party. The intermediary receives a fee for this service based upon the principal amount of the borrowing covered by the swap or upon the interest rate payments to be made. Although the intermediary undertakes each party's obligations vis-a-vis the other party, the actual risk incurred often is limited because the executed agreements may require the intermediary to make payments to one party only if offsetting payments have been received from the other.[203] Accordingly, the intermediary acts more in the capac-

199. *See Inside the Swaps Market*, INTERMARKET, Feb. 1986, at 38; *Rate Swaps Draw Concern*, N.Y. Times, Feb. 7, 1985, at Dl.

200. *Rate Swaps Draw Concern*, N.Y. Times, Feb. 7, 1985, at D1. *See* INTERNATIONAL SWAP DEALERS' ASSOCIATION, *supra* note 198, at §§ 12.1-.6 (1985).

201. *Interest-Rate Swaps Catch On At Banks, Thrifts*, AM. BANKER, May 4, 1983, at 9; *Banks' Swap Business Booms*, AM. BANKER, June 10, 1985, at 17; *The $150 Billion Baby*, BARRON'S, Aug. 19, 1985, at 36-39.

202. *See supra* note 201.

203. *Id.* The use of banks and other institutions as intermediaries in connection with swaps, however, has raised serious concerns among banking regulatory authorities and others over the risk incurred. In particular, the intermediary actually may assure each party

ity of a clearinghouse or banker than as an actual principal to or guarantor of the agreements.

As might be expected, swap agreements have become tradable financial instruments among the institutions involved. This trading essentially involves the transfer of the rights and obligations undertaken by one party to an agreement to another party not involved in the original agreement.[204] As the swap market has grown and developed, the existence of numerous swap agreements in a wide variety of forms has enabled many entities to enter into such agreements without the requirement of finding a suitable second party at the outset. Instead, an intermediary may sell the party a swap previously entered into by another entity that has decided it no longer needs or desires the agreement.

Another type of interest rate protection program that banks, brokerage firms, and other financial institutions offer is the "ceiling" or "floor" product. A typical ceiling rate instrument generally involves a financial institution's sale of a fixed commitment to make payments to the purchaser if interest rates rise to a stated level. For example, an institution may enter into an agreement with a customer that assures the customer of an interest rate ceiling on borrowed funds, which may be subject to a variable interest rate. For a fee, the institution will agree to pay the customer the difference in interest between that rate and an indexed rate specified in the agreement, multiplied by a given principal amount.

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of the other's payment and obligate itself to pay the fixed or floating amounts if one party defaults, although the intermediary is not liable for principal payments. *See Rate Swaps Draw Concern*, N.Y. Times, Feb. 7, 1985, at D1; *Inside the Swaps Market*, INTERMARKET, Feb. 1986, at 38. Moreover, because the intermediary, in effect, is fully hedged—one party's payment obligations offset those of the other party—the intermediary's liabilities under the swap ordinarily are not disclosed on financial statements nor included on balance sheets. *Rate Swaps Draw Concern*, N.Y. Times, Feb. 7, 1985, at D1. This "off-balance sheet risk," however, has increased regulatory authorities' concern over the potential for abuse. As a result, both the Federal Reserve Board and the Federal Home Loan Bank Board have implemented guidelines for the institutions under their supervision to reduce their exposure with respect to swaps. Federal Reserve Board Release, *reprinted in* [1984 Transfer Binder] Fed. Bank. L. Rep. (CCH) ¶ 99,858) (Feb. 9, 1984). In fact, the concept of "swap futures" has been proposed as a means of dealing with this intermediary risk. *See Inside the Swaps Market*, INTERMARKET, Feb. 1986, at 38.

204. *Our Wildest Dreams*, FORBES, July 30, 1984, at 53, 56-57; *The Incredible World of Swaps*, EUROMONEY, Nov. 1983, at 60-75. Indeed, the Chase Manhattan Bank in New York now provides a computer service that allows traders to get up-to-the-minute interest rate swap quotations. INSIDE THE SWAPS MARKET, INTERMARKET, Feb. 1986, at 36. The system, known as CHESS (Chase Electronic Swap System), may be accessed by a personal computer, and gives comparisons between swaps and other types of financial instruments, such as financial futures, commercial loans, and private placements. *Id.*

Similarly, the institution also may enter into an agreement that assures an individual or entity seeking to invest funds or property to be acquired or obtained in the future that it will receive not less than a stated amount of interest for a specific period of time. Offerors generally do not repurchase their obligations under these interest rate agreements, although they may do so under certain circumstances. The agreements ordinarily are not transferable or assignable and, for the most part, are sold only to large or institutional customers that require interest rate protection in connection with their trade or business. An institution may offer this type of interest rate product either in connection with a loan or deposit with that institution or without any connection to the customer's other business conducted with the institution.

Financial institutions also may offer options on interest rates. These options provide customers the right, but not the obligation, to obtain, at a specified time in the future, an interest rate on borrowed money that is no higher than a fixed ceiling or, in the case of funds to be deposited, a rate no lower than a stated floor. The customer, however, is not obligated in either instance to exercise its right, but simply may allow it to lapse.

A customer anticipating the receipt of a loan at a rate to be determined in the future, therefore, may be assured of a rate no higher than an agreed upon level in return for the payment of a nonrefundable premium. If interest rates rise above that level, the customer can exercise the option and receive the difference between the actual rate and that specified in the contract. As a result, the customer, for the cost of the premium, will have protected itself sufficiently against fluctuations in its loan rate. Similarly, a customer seeking to deposit funds at a future date may purchase a forward contract that assures a return of no less than a stated amount. If the rate the customer later receives on those funds is below that specified in the agreement, the customer, at its election, may exercise its right to receive the difference from the offeror.

In most instances, these instruments do not appear to contain the elements of an "investment contract" described above and, therefore, may not be subject to SEC regulation as securities.[205] Although an investment of money arguably occurs, it is difficult to claim that the "investor" is dependent in any way upon the efforts of a third party, and no pooling of investments is apparent, at least

205. *See supra* notes 104-16 and accompanying text.

in the context of a bilateral swap or ceiling rate agreement. More to the point, however, these contracts do constitute "evidences of indebtedness" because one party is obligated to make payments to another, either as a fixed requirement or dependent upon certain events. Indeed, the actual undertaking of one of the parties to a swap or ceiling agreement often is structured and designated as a promissory note.

Moreover, whether many of these transactions are of an "investment" or "commercial" character is unclear. As set forth above, their characterization as investments could result in treatment and regulation as securities.[206] Furthermore, the interest rate agreements may be of sufficient duration to qualify as long-term commitments, and the parties, or at least one party, most likely will not be in the business of dealing in interest rates. Nevertheless, a strong argument can be made that most, if not all, interest rate agreements are entered into for "commercial" purposes, regardless of the precise designation, terms, and duration of the actual contracts. In particular, virtually all of the parties to a swap or ceiling agreement enter into such transactions to protect against fluctuations in interest rates that could increase their cost of doing business. Viewed in this light, the transactions clearly have an integral relationship to the entity's commercial activities. Furthermore, because such instruments are used primarily for hedging reasons, they are removed, for the most part, from the "investment" rubric: no expectation of profit or anticipation of speculative gains exists. To the contrary, the goal is to limit adverse consequences caused by market fluctuations.

In any event, the characterization of swaps or ceilings as securities may not have a significant impact on the ability of financial institutions to trade them. First, to the extent such instruments are marketed by banks, their offer and sale very well may be exempt from Securities Act registration based upon the exemption for bank securities.[207] Second, because of the nature of the participants in the off-exchange interest rate markets, it should be feasible in most instances to structure a transaction as a private offering, which also would eliminate the need for Securities Act registration.[208] This approach would preclude any general solicitation of parties or product advertising. It would permit, however,

206. *See supra* notes 177-24 and accompanying text.
207. 15 U.S.C. § 77c(a)(2) (1982).
208. *See supra* notes 135-49 and accompanying text.

the offeror to approach entities with which it has a preexisting business relationship or about which it has sufficient information to indicate an ability, a willingness, and a need to enter into the transaction.

Moreover, most, if not all, of the parties with which an offeror would be likely to seek to enter into a swap or ceiling agreement should fall within the definition of an "accredited investor," which explicitly encompasses banks and certain other entities. Accordingly, a finding that these types of instruments constitute securities will not present a significant constraint on their trading in most instances.[209] Nevertheless, this result could present a potentially significant ICA issue if swap transactions constitute a substantial portion of an entity's business. Under such circumstances, the "inadvertent investment company" problem described above could arise regardless of whether Securities Act registration is required.

The more difficult issue presented may be whether a swap or ceiling rate agreement constitutes a prohibited off-exchange futures contract subject to the CEA's prohibition on trading. On their face, such agreements do not appear to resemble futures contracts at all. Indeed, there is no delivery of any "commodity," nor could such a delivery be made thereunder. Significantly, however, an interest rate swap or ceiling in many respects is identical to a futures contract on a United States Treasury bond or bill, at least as far as the instruments' functions and effects are concerned.[210] Interest rate agreements, like Treasury bond futures, protect against fluctuations in interest rates, which could affect adversely the value of a securities or loan portfolio or obligation. An off-exchange interest rate agreement simply strips away any connection

209. Nevertheless, to the extent an interest rate swap transaction is deemed to be a security, an entity executing such a transaction on behalf of the principals could be deemed a "broker" within the meaning of the Exchange Act, and may be subject to broker registration. *See* WOLFSON, *supra* note 95, at ¶¶ 1.01-1.04. The definition of broker includes any person "engaged in the business of effecting transactions in securities for the account of others." 15 U.S.C. § 78c(a)(4) (1982). Determining broker status, therefore, may depend upon the remaining activities of a person executing swap transactions. In any event, the imposition of broker-dealer registration upon a person not otherwise required to register as a broker-dealer could result in substantial additional burdens.

210. *See* CHICAGO BOARD OF TRADE, TREASURY BOND FUTURES CONTRACTS (1985). Although a Treasury bond futures contract provides for the purchase and sale of actual Treasury securities, they most often are settled by liquidation and payment of offsetting amounts. Because the value of Treasury bonds is dependent almost exclusively on fluctuations in interest rates, these amounts, in essence, simply will reflect changes in interest rates multiplied by a given principal amount, as in the case of an interest rate swap.

to an identifiable issue of United States Treasury securities, but it maintains the relationship between the obligation and a specified market interest rate. Because that rate in any event may be based upon a Treasury rate, the agreement may function very much like a futures contract and achieve similar results. Of further interest is the settlement of certain futures contracts, primarily those based on indexes, through cash payments rather than commodity delivery.

Additionally, an interest rate agreement exhibits several futures contracts characteristics cited by the CFTC and the courts.[211] Certain terms may be standardized and agreements may be collateralized similarly to the margining of futures contracts. Specifically, swap agreements may include a requirement that one party deposit collateral and maintain that collateral at a specified level throughout the term of the agreement. This requirement even may be pegged to existing margin levels on Treasury securities futures. The liquidated damages provision of swap agreements also may serve the same purpose as a right to "close out" a position.

Similarly, the forward agreements on interest rates described above arguably could be construed as commodity options, because they are functionally similar to options on government securities.[212] The purchaser (the option holder) pays a nonrefundable purchase price (the premium) for the right, but not the obligation, to receive "delivery" of a commodity (in this case, a cash settlement based on movements in interest rates). Under this analysis, however, it appears more likely that these instruments would be found to constitute securities, because options on government securities, unlike futures on such securities, are themselves separate securities. In that event, it would be necessary to offer such options through a private offering, as described above, or pursuant to another Securities Act exemption.

Nevertheless, the agreements lack many of the salient characteristics of futures contracts. The instruments are customized, at least with respect to such essential terms as quantity and payment dates. In contrast, the terms of most futures contracts are completely standardized with the exception of price. Furthermore, although the parties may be required to deposit collateral, the contracts ordinarily are not margined in the same manner as futures contracts. Specifically, the agreements may not be "marked to

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211. *See supra* notes 10-27 and accompanying text.
212. *See supra* notes 38-66 and accompanying text.

market" at the end of every day and "excess margin" may not be subject to immediate release. Moreover, the liquidated damages provisions do permit a party to escape from a position, but not through the establishment of an offsetting position, as in futures trading; instead, the escape occurs through the payment of a predetermined amount of damages. In addition, the almost exclusive use of such instruments by entities seeking to hedge interest rate risk in connection with commercial businesses precludes public participation. The offering of these products to members of the general public or other parties not using them for commercial purposes likely would raise a significant CFTC problem, particularly if the instruments are detachable and separately tradable by persons not involved in the original party's commercial activities.[213]

In any event, the CFTC to date has not attempted to regulate interest rate agreements as futures contracts, nor has it enunciated a policy or position with respect to interest rate agreements. In part, this lack of effort may be due to the fact that such instruments largely are limited to financial institutions with interest rate exposure and are not offered to speculators generally or individuals in particular. In addition, the off-exchange interest rate market developed only in the late 1970s and early 1980s and grew rapidly and dramatically to extraordinary size. As a result, the CFTC may have concluded informally that regulation, or even a policy statement or interpretation, would be unwarranted and unfeasible particularly in view of the market's institutional nature.

B. *Options on Foreign Currencies*

Customers seeking to protect against a currency risk, rather than an interest rate risk, also may use options or futures-type instruments. An option on foreign currency provides the right, but not the obligation, to purchase or sell for a predetermined price a stated amount of a particular foreign currency at any point up to an agreed upon expiration date.[214] The purchase of an option to buy currency, therefore, allows a commercial entity with a commitment to purchase goods or services in a foreign currency at a fixed time in the future to "lock in" a maximum exchange rate to be paid for the needed currency. Conversely, an entity anticipating

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213. *See* Net Capital Rule, 50 Fed. Reg. 42,961 (Oct. 1985).

214. *See generally* Markham & Gilberg, *supra* note 41; *See also Controlling Risk With Foreign Currency Options*, EUROMONEY, Feb. 1985 (Special Supplement) [hereinafter EUROMONEY SUPPLEMENT].

receipt of a foreign currency and expecting a decline in the foreign currency's value prior to the date of delivery may purchase an option to sell the currency at a fixed price, or it may write an option requiring it to sell the currency upon the purchaser's exercise of the option.

The option writer most often is a financial institution, although many such institutions will permit their customers to write options, which the institutions may purchase at their discretion. Once a financial institution has written an option, it most often will seek to protect against the resulting exposure by entering into an offsetting transaction with another entity or on a futures exchange, or by covering its exposure by segregating physical currency.[215]

In contrast to many of the products discussed in this Article, options on foreign currency are traded both on organized exchanges and over the counter.[216] In the former situation, transactions are executed through brokerage firms in a public auction system, as are other exchange transactions in securities. The over-the-counter market operates as a dealer market, with all of a particular entity's customers entering into transactions with it on a principal to principal basis. Negotiations between parties therefore are direct as opposed to the more anonymous trading atmosphere of an exchange. In addition, over-the-counter options are more likely to be customized to the needs of the particular counterparty.

Options on foreign currencies, as noted above, represent perhaps the most confusing aspect of SEC and CFTC jurisdiction over financial instruments. In particular, under the Shad-Johnson Accord and resulting amendments to the various statutes, options on foreign currencies traded on a national securities exchange are within the exclusive jurisdiction of the SEC, but all other options on such currencies are within the province of the CFTC.[217] As a

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215. Although an option writer can hedge its risk through a multitude of methods, the clearest and most complete means of hedging is through the purchase of an offsetting option. *See* EUROMONEY SUPPLEMENT, *supra* note 214. Moreover, because exchange-traded options are in standardized amounts, these instruments seldom match an over-the-counter option written by an institution closely enough to provide an adequate hedge. As a result, an institution ordinarily will seek to cover its short over-the-counter option position with an offsetting long position in the off-exchange market.

216. EUROMONEY SUPPLEMENT, *supra* note 214.

217. *See supra* note 196 and accompanying text. As noted above, the regulatory status of currency options is unique because the SEC regulates the identical instruments when they are traded on a national securities exchange, and the CFTC regulates them when they are traded over-the-counter or on a commodities exchange. Currently, the Philadelphia Stock Exchange, regulated by the SEC, trades currency options, while the International

result, options on foreign currencies traded on the Philadelphia Stock Exchange or any other SEC-regulated securities exchange may be entered into only through a registered broker-dealer in accordance with exchange requirements.[218]

The CFTC exclusively regulates options on foreign currencies that are traded over the counter as well as options traded on contract markets and exchanges located in foreign countries.[219] As discussed above, the CEA and CFTC regulations prohibit the offer and sale of off-exchange options, subject only to a number of limited exemptions. These exemptions include "dealer options," which are offered by a commercial processor, merchandiser, or user of the underlying commodity, and "trade options," which are sold to a commercial user.[220] The dealer option exemption is useless for most entities seeking to offer options on foreign currencies, as it is restricted to firms that were both in the business of processing or merchandising the underlying commodity and granting options on such commodities in 1978.[221]

The trade option exemption, however, does permit the offer and sale of options on foreign currencies under certain circumstances. As discussed above, this provision permits granting an option to a person who is a producer, processor, merchant, or commercial user of the underlying commodity and who purchases the option in connection with his business.[222] Although foreign currency options do not fit precisely within the terms of this exemption, currency clearly is a "commodity" for CEA purposes, and an entity engaged in international commerce and subject to currency exposure should be construed to be a "commercial user" of currency. Based on this analysis, the CFTC staff held in an interpretive letter that currency options may fall within the trade option exemption, provided that the option meets the exemption's condi-

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Monetary Market of the Chicago Mercantile Exchange, regulated by the CFTC, trades currency futures and currency futures options. Many major institutions, however, trade primarily or even exclusively in the off-exchange market, because those transactions are more customized and can be effected privately.

218. *See* EUROMONEY SUPPLEMENT, *supra* note 214. Currency options traded on national securities exchanges are registered with the SEC under a "blanket" registration statement filed by the Options Clearing Corporation, the clearinghouse for all SEC regulated exchange-traded options. *See* OPTIONS CLEARING CORPORATION, *Characteristics and Risks of Standardized Options*, (Sept. 1985). This unique registration procedure has been established pursuant to SEC regulation. *See* 17 C.F.R. § 240.9b-1 (1986).

219. *See supra* notes 196 and 217.

220. *See supra* notes 55-66 and accompanying text.

221. *Id.*

222. *See supra* notes 60-61; *see also* 17 C.F.R. § 32.4 (1986).

tions.[223] In that instance, the staff was presented with the question of the permissibility of sales to United States persons of options on foreign currencies traded on an exchange outside the United States. The staff concluded that such sales may be made provided that the purchaser is a commercial user of the underlying commodity, is subject to the risk of fluctuations related to the specific currency underlying the option purchased, and provides written representations that the option is being purchased in connection with its business.[224]

Conversely, the grantor of a currency option may be prohibited from purchasing an option on the same underlying currency to protect itself against the risk incurred as an option writer, unless it has separate exposure in that currency.[225] The staff's concern is that the applicability of the trade option exemption depends upon the status of the purchaser, and allowing grantors to "bootstrap" themselves into the status of permissible offerees would circumvent the options ban and allow any individual or entity to operate essentially an off-exchange options business. Although it may be feasible in many, if not most, instances to offset a written option through the purchase of an option, this offset, based on the person's other business activities, may not be possible if the entity's

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223. CFTC Interpretive Letter No. 84-7, *reprinted in* [1982-1984 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 22,025 (Feb. 22, 1984).

224. *Id.* Although the instruments at issue in those instances in fact were traded on exchanges, the exchanges were located outside the United States. As a result, they were not CFTC-regulated contract markets, and the CFTC has taken the position that options traded in this manner are to be regulated in the same manner as over-the-counter options offered and sold in the United States. In fact, in 1978 the CFTC described the term "foreign commodity options" to mean "options on physical commodities or on commodity futures contracts which originate on or through the facilities of foreign exchanges," and has noted that such "foreign options may be offered under the trade option exemption." 43 Fed.Reg. 16,153, 16,157 (1978).

225. CFTC Interpretive Letter No. 84-7, *reprinted in* [1982-84 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 22-025 (Feb. 22, 1984). Specifically, the CFTC staff stated that:

> only a bank which engaged in Swiss Franc currency exchange transactions in its own behalf as part of its commercial banking activities could qualify as an exempt purchaser of options on Swiss Francs under Commission Rule 32.4. In this regard, the purchase of options on Swiss Francs would have to bear some direct, "non-speculative" relationship to the bank's Swiss Franc currency transactions in the cash forward market. Option purchases that exceeded any bona fide hedging requirements would be speculative and as such inconsistent with the trade option exemption. Moreover, a bank would be a qualified offeree only to the extent it purchased options as a principal for its own account and could not purchase options as an agent for its depositors or customers.

Id. at 28,595.

only exposure is the written option.

Nevertheless, the CFTC has made it clear that the commercial purpose for which an option is purchased need not satisfy the "bona fide hedging" requirements of CFTC regulations. To the contrary, provided that the transaction is entered into for legitimate business purposes, it does not appear necessary that it be a "perfect" hedge.[226] Furthermore, the CFTC has indicated some broadening of the permissibility of transactions in options traded on foreign exchanges. In particular, the CFTC has proposed a regulation that would permit the offer and sale in the United States of foreign futures or option contracts by registered entities, subject to a number of conditions.[227] In addition, in a recent release, the CFTC extended the clearance its staff provided to the entity requesting the interpretive letter cited above by stating that banks

226. *Id.* at 28,596. The precise nature of the required relationship an option purchaser must have with the underlying currency therefore is unclear at present. It appears, however, that, at least in the case of a hanking institution, a regular and ongoing connection with the underlying currency will he sufficient to support the entity's right to purchase options on the currency, regardless of whether each specific purchase is intended to hedge an identified currency position. In this regard, the CFTC staff noted that a "bona fide hedge transaction," as defined in CFTC regulations, is only one example of a permissible "non-speculative" purpose. Other commercial purposes may be acceptable, thereby suggesting that actual hedges are not required. *Id.* at 28,596 n.12. *See also* 17 C.F.R. § 1.3(z) (1986). With respect to non-banking entities, the permissible scope of option purchases is less clear; it seems reasonable to conclude that these entities also should be permitted to purchase options on currencies provided that the non-banking entities have some regular and ongoing exposure in the underlying currency apart from their options transactions, although it is less clear that their business is related directly to such exposure.

227. 49 Fed. Reg. 29,963 (1984); *see also* 51 Fed. Reg. 12,104 (1986) (to be codified at 17 C.F.R. Part 33). The CFTC has requested comment on a number of proposals which would require, among other things, that the writer as well as the purchaser of a trade option be a commercial user of the underlying commodity. 50 Fed. Reg. 10,786 (1985). This proposed requirement could serve to restrict further the availability of the trade option exemption for use in connection with off-exchange currency options transactions. Provided that "commercial use" is not defined in such a way as to be limited to bona fide hedge transactions, however, financial institutions and many large corporations should be able to utilize this market. Significantly, the CFTC also requested comment on the need for more objective standards in determining the status of permissible offerees. The release further suggested that CFTC regulations regarding leverage transactions may be applied in some analogous form of dealer options trading.

With respect to the offer and sale of foreign futures and options, the CFTC's proposal stated that persons engaging in such activities would be required to register with the CFTC and would be subject to a regulatory scheme similar to that imposed upon FCMs. 51 Fed. Reg. 11,905 (1986). The CFTC also proposed separate risk disclosure requirements specifically addressing the risks associated with foreign futures and options. *Id.* Particularly, the inclusion of options traded on foreign exchanges in this proposal represents a substantial departure from the CFTC's longstanding blanket prohibition on the offering of such instruments in the United States. *See* Markham & Gilberg, *supra* note 41, at 767.

in the United States may grant options on foreign currencies traded on foreign exchanges in addition to purchasing such instruments.[228] Significantly, however, the CFTC explicitly stated that this permissibility would not extend to financial institutions other than banks.[229]

C. *Forward Contracts on Foreign Currencies*

Apart from the trading of options on foreign currencies, many financial institutions, including most major banking organizations, participate in what is referred to broadly as the "interbank currency market," a loosely defined network of banks and dealers trading in foreign currencies literally around the clock in all parts of the world.[230] Transactions in the interbank market principally include "spot" purchases and sales of foreign currency, for immediate delivery; "swap transactions"; and forward transactions providing for delivery at a later date. These swap transactions are functionally similar to the interest rate swaps described above, but they operate in much the same manner as currency forwards. In contrast to options on currencies, however, a spot or forward contract requires the parties to undertake performance and does not provide for one party's election.[231]

Customers ordinarily enter into forward contracts in currencies based on units of the applicable currency, with customers required to pay the full purchase price upon settlement unless the position is closed out before that time. Customers usually are

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228. 51 Fed. Reg. 12,698 (1986) (to be codified at 17 C.F.R. Part 32). The problem cited earlier hy the CFTC in connection with the granting of options traded on foreign exchanges is that, by the very nature of exchange trading, the grantor cannot know who the purchaser of the instrument is and, therefore, cannot be assured that the purchaser is a commercial user of the underlying currency. Apparently reasoning that hanks are sufficiently engaged in currency transactions in connection with their regnlar business to permit this type of trading activity, the CFTC has relaxed the restriction in connection with banks. Nevertheless, the CFTC has stated that granting options traded on foreign exchanges is permissible only when the transactions are for hedging purposes as defined under the rules of the relevant exchange and when the CFTC has access to information regarding the transaction and the identities of the parties.

229. *Id.*

230. *See, e.g.*, S. REP. No. 1131, 93d Cong., 2d Sess. 49-51 (1974); CFTC v. American Board of Trade, 479 F.Supp. 1177 (S.D.N.Y. 1979); CFTC v. Sterling Capital Company [1980-1982 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 21,169 (N.D. Ga. 1981); City Bar Report, *supra* note 18.

231. *See* FEDERAL RESERVE BANK OF NEW YORK, RESULTS OF U.S. FOREIGN EXCHANGE MARKET TURNOVER SURVEY CONDUCTED IN APRIL 1983; FEDERAL RESERVE BANK OF NEW YORK, RECENT TRENDS IN THE U.S. FOREIGN EXCHANGE MARKET, Quarterly Report at 38-46 (1984).

charged commissions or markups that are calculated as a percentage of the United States dollar value of the transaction on a per-transaction basis. Forward transactions in currencies—often referred to as "FX" or "Forex" transactions—are executed through a customer's account with a bank acting as a dealer and market maker in the particular currency involved. Alternatively, the customer may deal with an intermediary, such as a brokerage firm, which in turn will place the transaction with a bank.[232]

Entities acting as dealers in the interbank market ordinarily are willing to deal with their largest customers on an unsecured basis, premised upon a long-standing business relationship with those customers and a thorough knowledge of their financial condition. Smaller or lesser known counterparties, however, may be required to deposit collateral in cash or securities to secure their exposure under a forward contract. This collateral ordinarily will be established as a percentage of the value of the customer's position, and additional collateral may be required, or excess collateral made available to the customer, as the value fluctuates.[233]

Some institutions will permit their customers to close out positions by entering into an offsetting obligation. For example, in the case of a forward contract to purchase currency, an institution will permit the customer to enter into a contract to sell an equivalent amount of the same currency on the same future date. This contract to sell will then extinguish the customer's commitment and only the differences will be settled on a net basis. In some instances, however, the institution may require the customer to maintain both sides of the offsetting transaction as open positions until maturity.[234]

Currency forwards may be used either for hedging or for speculative purposes. For example, a United States entity selling goods abroad and anticipating payment in a foreign currency may wish to assure that the exchange rate will not move against it prior to the time of payment. Therefore, the United States entity may enter into a forward contract to sell the quantity of currency it is to receive for a stated amount of United States dollars. Such instruments, however, also may be used for speculative trading by entities or individuals seeking to profit from an expected rise or decline in the value of the dollar or other currencies.

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232. *See supra* note 231; *see also* Shirreff, *Swaps—The Way Into Any Market*, EUROMONEY, Nov. 1983, at 60-75.

233. Shirreff, *supra* note 232.

234. *Id.*

A currency swap, though similar to an interest rate swap or forward currency transaction in some respects, is slightly more complex. This transaction involves an exchange of debt into another currency until maturity, when repayment is made in the original currency, often at a previously agreed upon exchange rate. Unlike an interest rate swap, a currency swap does not involve only a literal exchange of currency—which would constitute merely a spot transaction in foreign currencies—but rather involves a longer term protection against currency fluctuations for those parties with obligations expressed in different currencies. Accordingly, when the parties to a currency swap are exchanging equivalent amounts of different currencies, a formula is used to account for the differentials in interest and exchange rates over the term of the swap. For example, a party with a good credit rating in United States dollars, but with limited access to the Swiss franc market, might agree to swap fixed rate dollars for fixed rate Swiss francs in order to benefit from relatively low Swiss franc interest rates. Another party enters into the agreement to obtain cheap United States dollars that the first party can provide through its favorable credit rating.[235]

Because of the involvement of both exchange rates and interest rates in the context of a currency swap, these transactions are somewhat more complex than interest rate swaps, although the mechanics of the two are virtually identical. Currency swaps also are generally settled on a "net" basis in one or the other of the currencies involved, rather than by requiring actual payment in both currencies by the parties. In addition, a bank or other intermediary often is interposed between the two principals to the transactions for the same reasons noted above in connection with swap agreements.[236]

Because currencies themselves are not securities under the definitions set forth in the federal securities laws, forward contracts to purchase and sell currencies generally should not themselves be deemed securities. The principal regulatory problem arising from such instruments, however, is the CEA's ban on off-exchange transactions in futures contracts. As noted above, the Treasury Amendment to the CEA states that the statute does not apply to transactions in foreign currencies, unless conducted on a

235. *Id.* at 61.
236. *See id.* at 60-75.

board of trade.[237] On its face, therefore, the CEA leaves all purchases and sales of foreign currencies, whether for future or immediate delivery, outside its scope.

Nevertheless, the CFTC has stated that an informal network of brokers and dealers may be deemed to be a "board of trade," even when not formally organized as an exchange.[238] Moreover, based upon the Treasury Amendment's legislative history, the CFTC has stated that the exclusion of currency transactions from the prohibition on off-exchange futures trading applies only when such transactions are entered into by "sophisticated and informed institutions" and not when trading involves members of the general public.[239] The CFTC's reasoning appears to be that Congress intended in constructing the Treasury Amendment only to preclude the CFTC from exercising regulatory jurisdiction over currency trading between banks or other large financial institutions. When currency products are marketed to smaller individual traders, speculators, or others, however, the CFTC asserts that it can and must regulate the trading if it involves futures contracts.[240]

Accordingly, the CFTC's Office of General Counsel issued an interpretive release in 1985 which stated that off-exchange futures transactions in foreign currencies are within the terms of the Treasury Amendment—and therefore outside its jurisdiction—only when entered into by "sophisticated and informed institutions."[241] The release explicitly stated that it was not intended to apply to legitimate forward contracts in currencies, when the parties gener-

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237. *See supra* notes 28-37 and accompanying text.

238. CFTC Interpretive Letter No. 77-12, *reprinted in* [1977-1980 Transfer Binder] Comm. Fut. L. Rep. (CCH), ¶ 20,467, at 21,909 (Aug. 17, 1977). In that instance, the CFTC staff addressed the applicability of the Treasury Amendment to off-exchange trading of forward contracts on GNMA pass-through certificates. The staff noted that the term "hoard of trade" need not be limited to organized futures exchanges, but could include informal networks of dealers, where, among other things, transactions and products are marketed to members of the general public. The emphasis the CFTC and its staff places on the general public's involvement appears to he based upon a fundamental belief that the CEA, the CFTC, and the entire regulatory structure is designed in large part to direct public trading of futures-type instruments onto organized exchanges that provide protections not afforded to participants in many off-exchange trading arrangements. *See* Letter of Thomas R. Donovan, President of the Chicago Board of Trade, to CFTC Office of Secreteriat (Dec. 23, 1985) (regarding CFTC Statutory Interpretation and Request for Comment, 50 Fed. Reg. 42,983 (1985)). As a result, when marketing programs involve members of the general public, the CFTC is likely to find that the trading has been conducted on a "board of trade," whether organized or not, and that a violation of the CEA has occurred.

239. 50 Fed. Reg. 42,983, 42,986 (1985).

240. *Id.*

241. *Id.*

ally intend to make and receive delivery of the subject currencies and delivery in fact occurs in the overwhelming majority of instances.[242] The release instantly created an uproar among brokerage firms, banks, and other financial institutions that regularly enter into currency transactions with their customers. These entities expressed the strong concern that the CFTC's position would prevent them from conducting many of their legitimate business operations with customers who, while having substantial wealth and sophistication, might not be deemed to be "institutions" within the CFTC's definition.[243]

The CFTC received a number of comments from these parties in response to the release. In general, the comments espoused the following arguments: (1) the plain meaning of the Treasury Amendment is that Congress intended to preclude CFTC jurisdiction over all off-exchange transactions in foreign currencies, regardless of the parties involved; (2) as a practical matter, CFTC jurisdiction over the multi-billion dollar interbank market is impractical, unfeasible, and disruptive to an efficiently functioning system; (3) any attempt to identify those entities qualifying as "institutions" necessarily is arbitrary and unworkable; and (4) the entities engaging in currency trading already are regulated sufficiently by the CFTC or appropriate banking authorities.[244] In addition, the comments urged that, to the extent some regulatory oversight is necessary, this regulation could be accomplished in much less disruptive ways. For example, the CFTC simply could require registration of currently unregistered entities selling foreign exchange products, institute disclosure requirements, or adopt other criteria under which products could be marketed legally.[245]

Furthermore, several commentors argned that individuals always have played a role in currency transactions. The CFTC's attempt to limit its involvement on the basis of the Treasury Amendment, therefore, was unsupported by history or precedent. As a result, these commentors argued that a "sophisticated inves-

242. *Id.* at 42,985.

243. *See* Letters filed with CFTC Office of Secretariat in Response to CFTC Statutory Interpretation and Request for Comment, *supra* note 239. The General Counsel of the CFTC, Kenneth M. Raisler, also held a series of meetings with industry representatives in New York and Chicago to review the CFTC's position and to discuss its possible courses of action. *See* Mitchell, *The Treasury Amendment & Foreign Currency Forward Transactions*, COMMODITIES L. LETTER (Dec. 1985); Yeres and Bruckner, *Regulator Wants Currency Transaction Power*, AMERICAN BANKER (Jan. 1986).

244. *See supra* note 243.

245. *Id.*

tor" test similar to the test under SEC Regulation D should be extended to interbank trading.[246] The CFTC acknowledged informally, largely on the basis of a comment letter submitted by Merrill Lynch International Bank and Merrill Lynch Futures Inc., that individuals in fact had traditionally participated in the interbank market for many years and had done so at the time that Congress enacted the Treasury Amendment.[247]

The most significant comment in response to the release, however, was a letter from the Treasury Department stating that the Treasury Amendment is a "transactional exemption" not confined to purchases and sales among "sophisticated and informed institutions" and that the statute itself places no limitations on the coverage of the exemption.[248] Because the Treasury Amendment was included in the CEA at the Treasury Department's insistence, its views are entitled to great weight, and the CFTC, although it has issued no further public pronouncements on the subject, has indicated informally that it may rethink its entire position and perhaps depart from the interpretation set forth in the release.[249]

Despite the unequivocal terms of the Treasury Amendment itself, the legislative history is at best unclear. The CFTC's position that the exemption is limited to transactions entered into by so-

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246. *See, e.g.*, Comment Letter filed by Merrill Lynch Futures Inc. and Merrill Lynch International Bank with the CFTC Office of the Secretariat (Dec. 23, 1985).

247. *See Futures Industry Association*, CFTC Report, Apr. 14, 1986, at 3.

248. Letter of Charles O. Sethness, Assistant Secretary of the Department of the Treasury, to Susan M. Phillips, Chairman of the CFTC (May 5, 1986). In particular, the Treasury letter stated that:

> By its terms, the Treasury Amendment exemption is a transactional one that places outside the coverage of [the CEA] all off-exchange futures transactions in the listed financial instruments. In its interpretative statement, [CFTC] would limit the exemption to transactions between sophisticated and informed institutions. However, the Treasury Amendment itself contains no language limiting the coverage of the exemption based upon the characteristics of participants in a transaction.

Id. The Treasury noted that "it may be appropriate to bring some foreign currency futures transactions marketed to the general public off-exchange within the scope of the Commodity Exchange Act," but stated that Congress should make such a determination.

The Federal Reserve Board and the Comptroller of the Currency also submitted comments. *See* Letter of Michael Bradfield, General Counsel of the Federal Reserve Board, to Kenneth M. Raisler, General Counsel of the CFTC (Mar. 5, 1986); Letter of Owen Carney, Director, Investment Securities Division, Comptroller of the Currency, to CFTC Office of the Secretariat (Apr. 11, 1986). The Federal Reserve Board argued essentially that transactions of one million dollars or more should be deemed to be within the Treasury Amendment and therefore outside the jurisdiction of the CFTC, and that a subjective test, based on a customer's status and sophistication, should be applied to determine the permissibility of smaller transactions.

249. *See CFTC Staff Goes Back to Drawing Board on Treasury Interpretation*, SEC. WEEK, at 10-11 (May 19, 1986).

phisticated and informed institutions is supportable. Nevertheless, this position does not necessarily warrant exclusion of all individuals from the market. Rather, even if the CFTC wishes to retain its interpretation of the Treasury Amendment, it should simply recognize that many individuals operate in a similar manner to institutions when entering into interbank transactions and have done so since before 1974, the date of the Treasury Amendment's enactment. This recognition would permit the CFTC's regulations to articulate the types of individuals the CFTC believes are within the Treasury Amendment's terms. An "accredited investor" standard, which would be consistent with the CFTC's long-standing position on the matter, would be appropriate.

D. Commodity-Backed Bonds

In recent years a number of mining companies and other entities have begun to offer bonds backed in one form or another by physical commodities. For example, in 1980 the Sunshine Mining Company offered the public what it described as silver-indexed bonds.[250] These bonds, which were sold as securities registered with the SEC under the Securities Act, were redeemable at an "index principal amount," which was the greater of one thousand dollars or the market value of fifty ounces of silver for each one thousand dollars face amount of the bond. If the index principal amount was greater than one thousand dollars, the company could deliver, in lieu of that amount, fifty ounces of silver for each one thousand dollars face amount of outstanding bonds.[251] In effect, this feature operated as a "sweetener" for purchasers of the bond and permitted investors to receive the benefits of increases in the value of silver the company owned without being subject to a reduction in the investment's value if silver prices should fall.

Similarly, in 1981 the American Stock Exchange (AMEX) announced a proposal to trade put and call options on "bullion

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250. SUNSHINE MINING CO. PROSPECTUS (Apr. 19, 1980). The Sunshine Mining Company at the time operated the largest silver mine in the United States. The Company recently initiated an exchange offer for the bonds, offering to exchange tbem for securities bearing interest at a higher rate and indexed to a greater amount of silver. *Sunshine Mining Extends Exchange Offer on Bonds*, Wall St. J., Aug. 11, 1986, at 34.

251. SUNSHINE MINING CO., *supra* note 250. The prospectus stated that, as of the close of trading on February 10, 1983, tbe spot settlement price of silver on the Commodity Excbange, Inc. was $14.125 per ounce; at this price, fifty ounces of silver would have been valued at $706.25. Thus, a $293.75 increase in the value of the silver would have been necessary before the purchaser could receive any added benefit from this feature of the bond.

value demand promissory notes" (BVNs).[252] The BVN constituted a non-interest-bearing obligation of an AMEX issuer to pay an amount in United States currency equal to the market value of the number of ounces of gold or silver described in the note, based upon the London "fix" price for the particular metal on the business day immediately following the date of demand set forth in the note.[253] The AMEX proposed that options on BVNs would be traded at twenty-five dollar to four hundred fifty dollar exercise intervals for gold and fifty cent exercise intervals for silver. The AMEX stated that the proposal "would make it possible to shift risks associated with bullion ownership, while at the same time providing opportunities for investment in the trading of options on securities whose prices would be closely related to those of gold and silver bullion."[254] In effect, the AMEX proposal converted an investment in gold or silver into a security in the form of a promissory note. The proposal, however, was never effectuated. Instead, the AMEX began to trade options directly on gold in substantially the same manner as options on gold or silver are traded on the Commodity Exchange, Inc. (COMEX).[255]

More recently, issuers have developed variations on these products, including zero coupon bonds that provide for a minimum return that may be increased by an amount equal to the excess in price of a stated commodity price index at the time of maturity over the price at the time of sale.[256] This bond, which most often is

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252. 46 Fed. Reg. 55,044 (1981).

253. *Id.* The BVN was described in the offering materials as:

> [A] promissory note issued by an AMEX-approved issuer. It is a non-interest bearing obligation of the issuer to pay an amount, in U.S. currency, equal to the market value of the number of fine troy ounces of gold or silver bullion described in the note, based upon the price at which the bullion is fixed at the A.M. London fixing for the particular bullion on the business day immediately following the date of demand . . . .

Id.

254. *Id.* at 55,047.

255. 49 Fed. Reg. 43,745 (1984). *See generally Gold Bullion Options Approved by CFTC for New Amex Unit*, Wall St. J., Feb. 19, 1985, at 46. Pursuant to CFTC approval, the option was traded under the CFTC's pilot program for exchange-listed options. *See supra* notes 54-56 and accompanying text. Interestingly, however, trading in this option is conducted through a "board broker" system, a concept developed by the securities industry and adopted by the CBOE for the trading of options on securities. The "board broker," which maintains a "book" of customer orders and performs the role of the traditional exchange specialist in assuring an orderly market, has not been adopted in the futures history. *See* Markham & Gilberg, *supra* note 41, at 15, 744-75.

256. These instruments are substantially similar to Sunshine Mining Company bonds or BVNs, except they permit investors only to share in the value increase of specific quantities of commodities, rather than allowing customers to receive delivery of the commodities. In addition, they normally are appended as coupons to a traditional debt offering although,

attached as a coupon to a larger debt offering, does not permit the holder to obtain delivery of actual commodities, but it does allow the holder to benefit from a price rise during the term of the bond without being subject to the risk of falling prices. Other entities have offered bonds with detachable coupons providing the right to receive the dollar value of a stated quantity of gold or silver on the maturity date or to accept delivery of the actual metals. Commodity-backed bonds based on oil or indexes of oil prices recently have been introduced as well.[257]

These instruments generally are deemed securities because they operate, for the most part, like any other bond issued by a corporate entity. From the perspective of the securities laws, the only distinction from standard bond financing appears to be that the repayment obligation may be based on commodities prices, rather than a fixed or floating interest rate.[258] In any event, they clearly constitute evidences of indebtedness acquired for investment purposes. As a result, their issuance and sale in most cases must be made through a Securities Act registration or a private placement, unless another exemption is available. Because the instruments most often are sold in smaller denominations to many nonaccredited investors, the private offering exemption may not be available. Accordingly, with the exception of transactions that can be placed with a small number of institutions, the majority of these bonds are sold through registered Securities Act offerings.[259]

Under the CEA, however, a commodity-backed bond may be deemed to be either a futures contract or an option, depending upon its structure.[260] For example, a bond providing the right, but not the obligation, to receive delivery of a stated quantity of metals up to or on a fixed date in the future strongly resembles a standard commodity option on gold or silver. In return for a fee (a

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as discussed below, they may be detachable and separately traded.

257. *See Standard Oil Sells New Issue Linked to Price of Crude*, Wall St. J., June 23, 1986, at 30; Dutt, *Commodity-Linked Bonds Under Regulator's Scrutiny*, INVESTMENT DEALERS' DIG., at 14 (July 28, 1986); NRM ENERGY CO. PRELIMINARY PROSPECTUS (July 17, 1986).

258. This distinction, however, as discussed more fully below, is significant for purposes of the commodities laws. In particular, an obligation to make payments based upon fluctuations in the prices of commodities, or an obligation to deliver physical commodities, in many instances will be deemed to involve the offer and sale of an off-exchange futures contract or a commodity option.

259. *See* CFTC Division of Trading and Markets, Interpretative Letter No. 85-7 *reprinted in* [1984-1986 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 22,727 (Mar. 6, 1985).

260. For a discussion of the nature and definition of futures contracts, see *supra* notes 10-37 and accompanying text.

portion of the purchase price of the bond), the purchaser is granted the right, but not the obligation, to receive delivery of a stated quantity of metals. In contrast to a standard commodity option, the terms of these bonds most often will not require the purchaser to pay any additional amount for the metals. Arguably, however, the "strike price" and the "premium" simply have been collapsed into the purchase price of the bond.

Similarly, a bond that requires the purchaser to accept and the issuer to deliver a stated quantity of metals or its cash equivalent at a stated time in the future essentially operates like a futures contract. Although no margin payments are involved, the terms of the contract are standardized, and the instrument may be used to speculate in metals prices. In fact, this latter point probably is the strongest argument in favor of regarding these instruments as options or futures contracts under the CFTC's most recent analysis, which, as noted, has relied primarily on whether delivery is intended and actually occurs in most cases. When no delivery is intended or occurs, the product very well may be viewed as an opportunity for price hedging or speculation, and therefore as a substitute for exchange-traded futures contracts or options.

Based largely upon this line of reasoning, in 1982 the CFTC's Division of Trading and Markets issued an interpretive letter stating that so-called "commodity certificates" were likely to be deemed prohibited futures contracts or options if offered and sold.[261] In that instance, a company proposed to issue certificates providing purchasers with the right to a cash settlement equal to the price difference of a stated quantity of a given commodity or commodities between the time of purchase and settlement.[262] The

261. CFTC Division Trading of Markets, No-Action Letter (Aug. 10, 1982).

262. *Id.* The offering circular represented that the commodity certificates would be issued under the following terms and conditions:

> Certificates shall be issued for those months of expiration that the Company shall deem appropriate, shall typically be of 60-180 days duration at issuance, and shall expire at midnight on the first day of the month of expiration . . . . At any time prior to expiration the Holder may require the Company to redeem each $1,000 Certificate redeemed for cash equal to the 'Prevailing Price' of one 'Commodity Unit' . . . . At expiration the Holder shall receive for each $1,000 Certificate redeemed cash for equal to the 'Prevailing Price' of one 'Commodity Unit' or $1,000 whichever is greater. A 'Commodity Unit' shall be determined at issuance as a specified quantity of the underlying commodity and shall be based on such factors as, but not limited to, the price volatility of the underlying commodity, the duration of the Certificate, interest rates, and the demand for the Certificates . . . . The 'Prevailing Price' of the underlying commodity shall be defined as the average settlement price of the three trading days immediately prior to the date of redemption of the futures contract for the month corresponding to the month of the Certificate's expiration on the appropriate exchange

Division of Trading and Markets concluded that the offering of such instruments would violate the CEA because they could not be used for purchase, sale, and delivery of physical commodities, but only for purposes of price speculation.[263] Although the CFTC did not analyze the salient characteristics of futures contracts and options described above, it regarded this feature as significant enough in itself to warrant prohibition.

Significantly, however, the requesting entity in that instance was not engaged in a business involving the commodities underlying the certificates to be sold. Under such circumstances, the instrument does appear much more like a speculative vehicle. In contrast, when an entity such as a mining company offers bonds based upon the value of metals it owns, mines, processes, or otherwise handles in connection with its business, a strong argument can be made that the purchase of the bond is really an investment in the issuer itself, because the issuer's profit or loss likely will fiuctuate with the commodities' value. In such a case, fewer speculative elements are present. Moreover, many of these instruments include the commodity-based portion of the repayment obligation as a nondetachable aspect of a larger investment in the entity. As a result, it is less likely that this portion will be traded separately or that a secondary market in these portions could develop. This factor also supports the argument that such portions should be treated simply as an investment in the issuer and not as a distinct product subject to CFTC regulation.

In a subsequent no-action letter, the CFTC's Division of Trading and Markets stated that a company engaged in the business of acquiring, exploring, and developing precious metals mining properties could not offer and sell securities with attached "gold warrants," which provide the holder the right to purchase a fixed

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> . . . . The Certificates do not pay interest and commodity prices will have to rise over the investment period in order to provide a return equal to that of income producing assets, although substantial profits may sometimes be realized . . . . Under no circumstances shall the Holder require, nor shall the Company satisfy its obligations by, the delivery of the underlying commodity.

Id.

263. *Id.* Specifically, the Division of Trading and Markets stated that

> because tbe anticipated returns to Holders of commodity certificates are referenced to the prevailing prices of commodities trading on designated contract markets, the sales of tbose Certificates appear to constitute "dealings in commodities for future delivery that are or may be used for . . . determining the price basis of any such transaction in interstate commerce."

Id.

amount of the company's gold at a stated price.[264] The Division, in declining to grant the no-action position, noted that the warrants were detachable and transferable and operated in the same manner as commodity options.[265] Shortly thereafter, the CFTC's OGC responded to a request for a no-action letter regarding a Canadian company operating a precious metals mining business that proposed to issue "gold purchase warrants" in conjunction with an offering of preferred stock.[266] The warrants granted the holders the right to purchase a specific amount of gold at a stated price on four separate exercise dates or to cancel the warrant during a two year period.[267] The OGC rejected the argument that the refundability of a portion of the customer's payment negated a finding that an option had been offered, because the instrument had all the other essential characteristics of and operated as an option.[268]

Recently, the CFTC's OGC has indicated an increased willingness to permit the sale of debt instruments that contain "option-like" features. For instance, the OGC has stated that it may be permissible to offer commodity-backed bonds providing for the delivery of a stated quantity of metals or their cash equivalent, if the offering is made only to non-United States persons residing outside the United States or to United States persons provided the "exer-

264. CFTC Division of Trading and Markets, Interpretative Letter No. 85-7, *reprinted in* [1984-1986 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 22,727 (Mar. 6, 1985). The issuer in that instance had filed with the SEC a registration statement under the Securities Act covering 1,300,000 units, each unit consisting of one share of common stock, one common stock purchase warrant, and one gold warrant. Exercise of the gold warrants was subject to the issuer's production of sufficient gold during each calendar quarter. The warrants were exercisable only in increments of 0.5 troy ounces, representing fifty warrants, and the price of those warrants would be tied to a "base production cost," which initially was established at $300.00 per ounce but would be adjusted quarterly in proportion to increases or decreases in the Consumer Price Index. The Offering Circular gave no assurance that the issuer would produce any gold during the period for exercising gold warrants. The Circular also could not assure that adequate gold would be produced to permit exercise of all warrants.

265. *Id.* In particular, the Division of Trading and Markets stated that "the above-described warrants are detachable and transferable instruments that give the Holder the conditional right, but not tbe obligation, to purchase physical gold. Moreover, it appears that part of the purchase price of the . . . offer is directly attributable to the value of the gold warrant and thus would serve the economic purpose of a premium." *Id.* at 31,061-62.

266. CFTC Interpretive Letter No. 85-4, *reprinted in* [1984-1986 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 22,802 (Sept. 17, 1985). The offered units consisted of one share of preferred stock and four gold purchase warrants. The warrants and the share were traded separately on the Toronto Stock Exchange.

267. *Id.*

268. *Id.*

cise" can occur only outside the United States.[269] In addition, it may be possible to offer a coupon providing for a minimum return at maturity with a higher payment in the event of an increase in commodity prices, because this payment structure is more like a traditional bond than a commodity option.[270]

The latter possibility occurred when The Standard Oil Company made an offering of notes, attached to a debenture, that were separately tradable. Standard Oil issued the notes in denominations of one thousand dollars, with maturities of four and six years. Upon maturity the holders would be entitled to receive in cash the sum of (1) the principal amount of the note, plus (2) an additional amount as a premium equal to any excess of an identified crude oil price over twenty-five dollars, multiplied by a stated number of barrels of crude oil. The notes also were subject to redemption prior to maturity at the holder's option.[271] Although the CFTC has made no public statement on the issue and the CFTC staff reportedly favored taking action against Standard Oil, the CFTC Commissioners apparently determined that the "hybrid" nature of the instrument argued against any action.[272] In particular, the CFTC appears to have concluded that the notes were part of a larger investment vehicle and that the investment's option-like features did not predominate (*i.e.*, the relative values of the "debt" and "option" elements warranted characterization of the overall product as a debt security, rather than a commodity option).[273] As a result,

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269. *See* Dutt, *Twist Allows U.S. Investors to Buy Unusual Deal*, INVESTMENT DEALERS' DIG., at 21-22 (June 9, 1986). In that instance, Quadrex Securities Corporation, a United States hroker-dealer, placed $3,000,000 of a $25,000,000 convertible debt deal on behalf of Pegasus Gold Corporation with United States investors. The United States investors waived the right to receive actual gold bullion upon conversion. Instead, they agreed to sell their bonds overseas, obtaining the conversion premium in cash.

270. STANDARD OIL CO. PROSPECTUS (June 16, 1986). *See also* Monroe, *Standard Oil Sells New Issue Linked to Price of Crude*, Wall St. J., June 23, 1986, at 30.

271. *See* STANDARD OIL CO., *supra* note 270; *CBT Objects to New Oil-Indexed Bond Issues, Cites Off-Exchange Threat*, Sec. Week, July 28, 1986, at 6-7; *Commodity-Linked Bonds Under Regulator's Scrutiny*, INVESTMENT DEALERS' DIG., July 28, 1986, at 14.

272. STANDARD OIL CO., *supra* note 270; *see also* Monroe, *supra* note 271, at 30.

273. *See* R. Davis, *Are Indexed Oil Instruments Also Commodity Options?*, COMMODITY L. LETTER (July-August, 1986). Robert Davis, A CFTC Commissioner, argues that the "option-like" features of these instruments should be evaluated by ranking them on a "Continuum," based upon such factors as the value of the "premium" relative to the debt offering or the value of the indexed payment relative to the value of coupon payments. Those investments operating more like traditional options, says Davis, perhaps should be regulated as such and restricted to exchanges. In other instances, according to Davis, treatment such as that accorded dealer or trade options may be warranted.

In any event, the market itself may ultimately determine the need for CFTC regulation.

offering commodity-backed bonds appears to be permissible if (1) the offering is registered with the SEC under the Securities Act; (2) the transaction is structured primarily as an investment in the issuer, rather than in the underlying commodity; and (3) the "option-like" features are not the principal aspect of the offering.

Nevertheless, the CFTC has offered no guidance about the determinative factors in evaluating an investment's "option-like" features. Moreover, the emphasis on "option-like" features and relative values of debt and option elements appears to be misplaced. The analysis will almost certainly be complex, and perhaps inconclusive, and may serve only to confuse the issue. A better approach may be for the CFTC simply to adopt the position that SEC registration satisfies public protection concerns and therefore obviates the need for a CFTC role.

E. *Derivative Instruments on Exempt Securities*

Financial institutions also have offered, or have attempted to offer, a wide variety of derivative products on exempt securities that often exhibit characteristics of securities, futures contracts, or other regulated investment vehicles. Among these offerings have been proposals regarding pooled investments in portfolios of exempt securities, including United States government securities or municipal bonds.[274] For example, an entity may propose to buy a portfolio of underlying securities, deposit these with a custodian, and issue certificates of participation representing undivided interests in the pool. The dividend or interest payments to the investors represent each investor's pro rata share of the issuer's earned income on the entire pool of securities, less fees and expenses.[275]

See Sailing Rough for New Bonds Linked With Commodities, Wall St. J., Sept. 29, 1986, at 22.

274. *See, e.g.*, Buffalo Savings Bank, SEC No-Action Letter, [1982-1983 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 77,320 (Sept. 24, 1982); Gem Savings Ass'n, SEC No-Action Letter, [1983-1984 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 77,528 (July 14, 1983); Hereth, Orr & Jones, Inc., SEC No-Action Letter, [1982-1983 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 77,319 (Sept. 24, 1982).

275. *See supra* note 274. For example, in the Buffalo Savings Bank letter, the bank proposed to offer and sell non-transferable certificates representing participations in tax-exempt securities issued by municipal and other governmental authorities. Each participation certificate would be related to a particular municipal security that would be identified in the certificate and would provide the owner with an undivided interest, to the extent of the amount stated, in such security. Similarly, in the Hereth, Orr & Jones, Inc. letter, the request concerned the issuance and sale of a series of non-redeemable mortgage pass-through certificates that evidenced fractional undivided interests in a pool of tax-exempt industrial development bonds, secured primarily by first mortgages on or deeds of trust

A more limited number of institutions offer participations in the principal or interest components of United States Treasury securities, transactions which involve sales of rights to interest payments on individual securities apart from rights or interests in the principal amount. Prominent among these instruments are Treasury Investment Growth Receipts (TIGRs), offered by Merrill Lynch, Pierce, Fenner & Smith, Inc. (Merrill Lynch) and Certificates of Accrual on Treasury Securities (CATs), offered by Salomon Brothers, Inc. (Salomon).[276] TIGRs and CATs represent ownership of the various component parts of United States Treasury bonds that Merrill Lynch or Salomon has purchased. For example, a particular series of TIGRs or CATs may provide the holder with the right to receive payment of interest or principal due on a specific Treasury bond. The underlying bonds are purchased, placed with a custodian, and held by the custodian until maturity pursuant to a custody and agency agreement. In exchange for the bonds, the custodian creates receipts (TIGRs or CATs) that evidence a direct ownership interest in a portion of the underlying bonds' interest payments or principal.[277]

TIGRs and CATs are sold in registered form only. The custodian registers the certificates in the name of the investor or, if the receipts are held in "street name," in the name of the investor's broker. In the latter situation, the broker identifies the investor on its own books. TIGRs and CATs are transferable and are traded actively in secondary markets maintained by Merrill Lynch, Salomon, and other institutions. Merrill Lynch and Salomon are compensated for their sales of TIGRs and CATs through the spread between the aggregate price received for such instruments from in-

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conveying real property. The return on certificate holders' investments would consist of the obligors' principal and interest payments on the tax-exempt mortgage loans. All payments and collections on the loans, with the exception of expenses, pass through to the certificate holders. Additionally, in a number of instances, this arrangement has been established with respect to certificates of deposit. *See, e.g.*, E.F. Hutton & Company Inc., SEC No-Action Letter, [1984-1985 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 77,909 (Nov. 28, 1984); Management Corp. of America, SEC No-Action Letter, [1982 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 77,210 (Mar. 8, 1982); Josephthal & Company, Sec. No-Action Letter, [1974-1975 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 80,116 (Nov. 25, 1974); Underwood, Neuhaus & Co., Inc., SEC No-Action Letter, [1974-1975 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 80,156 (Sept. 6, 1974). In a 1985 decision discussed below, however, the Second Circuit held that a brokerage firm selling bank certificates of deposit had violated the Securities Act through the offer and sale of unregistered securities. Gary Plastic Packaging Corp. v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 756 F.2d 230 (2d Cir. 1985).

276. Offering Circular, Treasury Investment Growth Receipts, Series 14 (July 6, 1984); Offering Memorandum, Certificates of Accrual on Treasury Securities (Nov. 28, 1983).

277. *See supra* note 276.

vestors and the cost of acquiring the underlying bonds, plus related transaction expenses.[278]

TIGRs and CATs are sold in three forms: (1) serial instruments, representing a direct interest in one of the semiannual interest payments due on the underlying bonds; (2) principal instruments, representing ownership of the principal due on the underlying bonds (principal TIGRs and CATs are offered only on bonds not subject to redemption prior to maturity); and (3) callable instruments, issued in connection with a series of bonds that are subject to maturity before redemption, representing ownership of such bonds' principal payable at maturity and representing each of the semiannual interest payments due on the bonds commencing on the first interest payment date following the first optional redemption date.[279]

In February 1985 the United States Treasury initiated a program designated as Separate Trading of Registered Interest and Principal of Securities (STRIPS), which was intended to "facilitate the stripping of Treasury securities by private market participants."[280] Under the STRIPS program, future interest and principal payments on certain long-term Treasury securities may be maintained separately in the Federal Reserve Board's book-entry system. An institution that is a member of the Federal Reserve System may request to have eligible Treasury securities separated into their component parts and made available for sale in such parts, although the Treasury does not itself offer and sell the components.[281] Three types of STRIPS are available for purchase: (1) individual coupons on a noncallable security; (2) the principal component of a noncallable security; and (3) the block of interests constituting the principal of a callable security and the last ten interest payments that are contingent on such security's not being called.[282]

When purchasers obtain fractional undivided interests in a pool of exempt securities, a separate security is almost certain to have been created. Under the *Howey* analysis, each purchaser has invested a sum of money in a "common enterprise," represented by the securities pool.[283] The requisite commonality most likely is sat-

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278. *Id.*
279. *Id.*
280. Questions and Answers on STRIPS, Dep't of the Treas., Release (Jan. 15, 1985).
281. *Id.*
282. *Id.*
283. *See supra* notes 104-116 and accompanying text.

isfied because each participant's profit or loss is completely interdependent with that of other investors. In other words, each participant receives its pro rata share of income or loss from the pool. Moreover, the success of the venture is dependent upon the efforts of a third party because profit or loss will be determined by the skill of the issuer in selecting the securities to be placed into the pool.[284] This type of arrangement also almost certainly will be deemed to be an "investment company" for purposes of the ICA. The pool plainly is "primarily engaged" in the business of investing or trading in securities and, under any of the ICA tests described above, likely would be subject to regulation as an investment company.[285]

The more difficult question arises when participants obtain direct interests in underlying securities, rather than fractional undivided interests in a portfolio. Under such circumstances, the commonality required under *Howey* seemingly is absent, because each participant's investment is in one component of an individual security, not in a group or pool of securities. The investor simply receives whatever interest or principal payments are due from the security's issuer. Furthermore, there would not appear to be any dependence on the efforts of a third party because the purchaser's income, if any, derives solely from the issuer of the underlying security, which is the United States government in the case of Treasury securities.

In this regard, the SEC staff stated in one instance that a stripping of the principal and interest components of Treasury securities did not involve the issuance of a separate security.[286] In

284. SEC v. American Bd. of Trade Inc., 751 F.2d 529 (2d Cir. 1984). In *American Bd. of Trade*, the court found interests in pools of Treasury bills and commercial paper to constitute separate securities requiring registration under the Securities Act. *Id.* at 537. In addition, the pool itself was deemed to he an investment company subject to registration under the ICA. *Id.* at 536. The interests had been sold in denominations of as little as $1,000, despite the availability of the Treasury bills themselves in minimum denominations of $10,000. Investors had been given "safekeeping receipts," held by the American Board of Trade in denominations bearing no relation to any particular customer's investment, and upon a demand for redemption by a customer, the American Board of Trade simply paid the customer out of its own funds. As a result, investors had no direct interest in the underlying securities.

285. *Id.* at 536. *See supra* notes 150-63 and accompanying text. As discussed above, the "primarily engaged" definition of an investment company is based on a subjective analysis of the entity's business and on whether it holds itself out as an investment vehicle. Accordingly, no requirement that any particular percentage of the entity's assets be invested in securities existed.

286. Lehman Brothers Kuhn Loeb, Inc., SEC No-Action Letter, [1981-1982 Transfer Binder] Fed. Sec. L. Rep. (CCH)¶ 77,045 (July 22, 1981).

that case, the offeror purchased existing securities, detached the interest coupons from them, and sold the bond and the coupon separately, arguing that the mere act of detaching the coupons from the bonds did not alter the character of the underlying instrument and did not make the offeror anything other than a dealer in securities.[287] In addition, the Treasury's operation of the STRIPS program lends further support to the conclusion that stripping does not result in the creation of a separate security, because the selling institution in the case of STRIPS necessarily creates the zero-coupon instrument that is sold to investors. Indeed, in the case of TIGRs and CATs, Merrill Lynch and Salomon are not responsible for the delivery of the coupon, which is undertaken by the custodian.

The separate security issue was most recently addressed by the Second Circuit in *Gary Plastic Packaging Corp. v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*[288] In *Gary Plastic* the court found that a certificate of deposit offering was subject to the antifraud provisions of the securities laws because the broker selected the certificates of deposit for sale to its customers, negotiated beneficial interest rates, and offered to maintain a secondary market in the instruments. In contrast, a purchaser of TIGRs or CATs receives direct rights in an underlying security that has not been specifically structured, selected, or negotiated for sale to such purchaser. Under this analysis, investors simply receive the rights obtained by the purchaser of the underlying security, but the investors are not "investing in" the purchaser's expertise in identifying investments or in negotiating beneficial rates or prices. Merrill Lynch and Salomon are not involved in establishing or negotiating the underlying securities' terms. Although Merrill Lynch and Salomon maintain secondary markets in TIGRs and CATs, a number of other institutions do so as well; investors, therefore, are not dependent upon Merrill Lynch or Salomon for resales. This issue currently is the subject of litigation initiated by customers of Mer-

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287. *Id.* at 77,618.

288. 756 F.2d 230 (2d Cir. 1985). In *Gary Plastic*, the brokerage firm selected bank certificates of deposit from a variety of issuers; represented that it would monitor the creditworthiness of the issuing banks on a regular basis; and offered to maintain a secondary trading market in the certificates. The court found that customers were investing in and relying upon the skill and expertise of the brokerage firm, because the customers' profits or losses would be based largely upon the brokerage firm's selection of particular certificates of deposit and its maintenance of a secondary market in those certificates of deposit. *Id.* at 240-41.

rill Lynch who had purchased TIGRs.[289]

Litigation also has raised the issue of whether this type of product results in the establishment of an investment company under the ICA. In a series of no-action letters in the early 1980s, the SEC staff identified three significant factors in its determination of whether a pooling arrangement involves the issuance of separate securities and the creation of an investment company under the ICA: (1) whether participants are aware of the securities in which investments are made prior to the time of purchase; (2) whether the manner in which purchase payments and payments on maturity are made present a risk of loss separate from and in addition to that presented by the underlying investment; and (3) whether any collateral features are present, such as the making of loans to participants to enable them to receive cash prior to maturity or sale of the securities.[290]

Based upon its analysis of these factors, the SEC has determined that aggregating individual investors' funds to purchase large denomination securities that otherwise might be unavailable to the individual investors does involve the offer and sale of a security and the formation of an investment company.[291] In contrast, when the beneficial owner of a participation has a direct interest in the underlying security and the right to proceed individually and directly against the issuer, pooling is less likely to create a separate security.[292] As noted, in the case of TIGRs and CATs no pooling of securities or issuance of fractional undivided interests occurs; purchasers receive direct interests in identified securities.

Moreover, under the ICA analysis set forth above, the sale of TIGRs and CATs appears to be far removed from the requirements either of a deliberate or an "inadvertant" investment company. Because the purchasers of such instruments receive direct interests in components of the underlying securities, there is no

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289. Krome v. Merrill Lynch & Co., Inc., No. 85-765 (S.D.N.Y. filed 1985). The case is in the preliminary stages and no decision has yet been rendered.

290. North Carolina State Employees' Association, Inc., SEC No-Action Letter (March 13, 1980); Green's Farm Agency, SEC No-Action Letter (March 15, 1980); Frascella, Russell B., C.P.A., SEC No-Action Letter (April 18, 1980).

291. *See, e.g.*, National Ass'n of Securities Dealers, Inc., SEC No-Action Letter, [1974-1975 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 80,130 (January 24, 1975). In that instance, funds of customers were going to be aggregated in order to purchase large denomination participations in larger "master note" agreements.

292. *See* Best Product Co., Inc., SEC No-Action Letter (Feb. 11, 1980); Prudential-American Securities, Inc., SEC No-Action Letter, [1974-1975 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 80,106 (December 27, 1974); Blythe, Eastman, Dillon & Co., SEC No-Action Letter (May 21, 1975); Bankers Trust Company, SEC No-Action Letter (July 4, 1982).

investment in an "entity" at all, much less an entity engaged in securities trading with the funds of participants. Purchasers of TIGRs and CATs clearly are not investing in Merrill Lynch or Salomon, because the obligor with respect to payments is the United States Government.

As these custody, pooling, and participation arrangements have become more common in the municipal and Treasury securities fields, the questions of whether a separate security and an investment company are created have arisen more frequently, although the issues have not yet been clearly resolved.[293] In any event, these programs almost certainly do not involve CEA or CFTC issues, unless they represent a forward delivery program in which delivery is not intended and in fact does not regularly occur.[294]

F. Commodity Financing Programs

Most banks and many other financial institutions operate commodity financing programs that involve secured loans to customers for the purchase of physical commodities. In its simplest terms, a commodity financing program involves a bank loan of money to allow a customer to purchase a commodity, secured by the customer's grant of a security interest to the bank in the purchased commodity. The security interest may be perfected through a Uniform Commercial Code filing with the appropriate state and local agencies or through possession by the bank of warehouse receipts representing title to the commodities.

In such instances, the bank generally will loan a percentage of the commodity's current market value to the customer and may require that this percentage be maintained. As a result, the customer will have to post additional collateral as the value of the

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293. *See supra* note 292. *See also* Gary Plastic Packaging Corp. v. Merrill Lynch, Pierce, Fenner, & Smith Inc., 756 F.2d 230 (2d Cir. 1985). A number of institutions also offer options or other derivatives on exempt securities. For example, Merrill Lynch recently initiated trading in options on mortgage-backed securities, designated as Options to Purchase or Sell Specified Mortgage Securities (OPPOSMS). The instruments available under the program include puts and calls on GNMA certificates, Federal National Mortgage Association certificates, and other mortgage-backed securities. *Merrill Develops "OPPOSMS," Options on Mortgage-Backed Securities*, Sec. Week, Dec. 23, 1985, at 5.

294. *See, e.g.*, Abrams v. Oppenheimer Gov't Sec., Inc., 737 F.2d 582 (7th Cir. 1984). As discussed above, the Treasury Amendment to the CEA exempts agreements for the purchase and sale of government securities and other types of financial instruments from CFTC jurisdiction unless such contracts constitute futures contracts traded on a board of trade. *See supra* notes 28-37 and accompanying text.

existing collateral diminishes because of market fluctuations. In addition, banks may finance customers' trading on the futures markets by extending loans for margin commitments or deliveries.

Other types of financial institutions offer financing programs that are not tied as clearly to actual purchases of physical commodities. For example, a brokerage firm or dealer may offer its customers the opportunity to finance purchases of gold or silver, secured by the purchased metals.[295]

In contrast to bank financing, however, sometimes neither the brokerage firm nor the customer actually owns the underlying metal. Instead, the brokerage firm merely may undertake a "short" obligation to deliver the metal upon the customer's satisfaction of the loan obligations. The customer ordinarily does not receive title to the metals, but simply is listed on the seller's books as having "purchased" the commodities. Moreover, the institution may rehypothecate, pledge, or sell the metal the customer purchases to one or more other customers during the term of the loan. Thus, whether the customer actually has received title to physical gold or silver, or simply has entered into a contract to buy the metals at a later date for a price fixed in the contract with interest and carrying charges imposed in between, is not quite clear.[296]

Under virtually all circumstances, a commodity purchase through a financing arrangement that requires the purchaser to pledge the commodities as collateral will raise no issues under the securities or commodities laws.[297] Similarly, when the purchaser buys the commodities outright and then pledges them as collateral for the extension of a subsequent loan, no significant issues should be raised. In contrast, when the entity extending the financing also

295. *See generally* Gilberg, *supra* note 9; City Bar Report, *supra* note 18. Icfn] note 292. *See also* Gary Plastic Packaging Corp. v. Merrill Lynch, Pierce, Fenner, & Smith Inc., 756 F.2d 230 certificate," for which they charge a mark-up or commission for their services. This certificate allows the customers to take legal title to a specified quantity of gold or silver, which is stored in a vault or depository. A certificate or similar instrument issued to the custemer setting out the type and quantity of metal purchased evidences ownership.

296. Gilberg, *supra* note 9; City Bar Report, *supra* note 18.

297. Both the SEC and the CFTC have taken the position that actual purchases of physical gold or silver, when physical delivery of the metals or a document of title to the purchaser occurs, are outside their jurisdiction and raise no regulatory concerns. *See, e.g.*, CFTC Interpretive Letter No. 85-2, [1984-1986 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 22,673 (Aug. 6, 1985); *Commodity Investment Fraud II: Hearings Before the Permanent Sub Comm. on Investigations of the Senate Comm. on Government Affairs*, 98th Cong., 2d Sess. 199-203 (1984) (statement of John M. Fedders, then Director of the SEC Division of Enforcement) [hereinafter Fedders' Testimony]. *See also infra* notes 311-317 and accompanying text.

is the seller of the underlying commodities, and title to the commodities has not passed in fact, substantial issues could arise under the CEA and state law.

In particular, some entities may agree to sell precious metals to a customer through a financing arrangement that allows the customer to pay a percentage of the total purchase price with delivery scheduled some time in the future.[298] The seller, however, in fact may not own the metals at the time of the sale and either may hedge its commitment to the purchaser through transactions in exchange traded futures contracts or simply may leave itself exposed. In addition, the purchaser may have the right to resell the metal at any time before actually taking delivery.[299] Under such circumstances, the purchase and financing agreements, in conjunction with each other, could be construed as operating in a manner similar to futures contracts. The amounts due on the loan often are substantially identical to margin payments, and delivery is neither intended nor made and accepted in most instances. Alternatively, many of these transactions exhibit the characteristics of the leverage contracts described above. They involve a percentage payment of the purchase price at the outset, periodic carrying charge or fee payments on the unpaid balance, and the seller's repurchase of the metals, often at the purchaser's demand.

Nevertheless, if the transaction does constitute a bona fide purchase and sale and title to the metals in some form passes to the purchaser, the transaction should not be deemed to involve a futures or leverage contract. In a 1985 no-action letter, the CFTC's Office of General Counsel concluded that such a financing arrangement between a bank and a metals dealer would not violate the CEA or CFTC regulations.[300] In that instance, a bank proposed to enter into purchases and sales of precious metals with several metals dealers, with settlement on each transaction occurring within two business days of the contract's date. The bank would deliver the metals either by delivering the physical metal to the dealer or by segregating the metal for the dealer in its vaults or in a third party's vaults. Subsequently, in some instances the dealer would resell the metals to its own customer, either on the basis of full payment of the purchase price or through a financing arrangement between the purchaser and the bank. The purchaser would receive

298. *See supra* note 297.

299. *Id.*

300. CFTC Interpretive Letter No. 85-2, [1984-1986 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 22,673 (Aug. 6, 1985).

a confirmation from the dealer indicating that ownership of the metals had been transferred to the purchaser. The bank also was obligated to notify the customer that it was holding metals on the customer's behalf. Under either the full purchase or financing approaches, the purchaser would be permitted to borrow against the metals up to a certain specified amount.[301]

The OGC first noted that the full purchase price would be paid in all of the contemplated transactions and that ownership to the metals in some form would be transferred within a short period of time.[302] Specifically, the dealer would pay the full purchase price to the bank, and the dealer's customer would pay the dealer the full purchase price either on its own or through financing extended by the bank. In addition, either documents of title or confirmations representing ownership would be transferred upon sale. On this basis the OGC concluded that the transactions could not be deemed leverage contracts because title always would pass in less than ten years and no periodic carrying charges or fees would be imposed.[303]

This conclusion appears to be in accord with the generally accepted leverage contract definition.[304] First, under the CFTC's recently adopted regulations, the financing contracts were excluded from the definition of a leverage contract because their duration was less than ten years. More importantly, however, no percentage payment of the purchase price to a dealer, with the remainder financed by that dealer, occurred. To the contrary, the dealer paid the full purchase price. The dealer's customer financed the transaction through the bank, not the dealer. As a result, the transaction was more like a traditional bank financing arrangement. Moreover, title actually passed to the purchaser at the time of settlement.

With respect to the status of these instruments as futures contracts, the OGC stated that because delivery would occur—either through transfer of documents of title or confirmation—within two business days, the agreements "lack that element of futurity which is an essential characteristic of a futures contract, and would, in all material aspects, be more in the nature of spot transactions with

301. *Id.* In that instance the bank indicated that metals might not be segregated in all instances, and that, in such cases, ownership of the metals by the dealer's customer would be reflected only by book entries on the bank's and the dealer's records.

302. *Id.*

303. *Id.* at 30,856.

304. *See supra* notes 69-83 and accompanying text.

delivery of and payment for the underlying commodity occurring essentially contemporaneously with the execution of the transaction."[305] The OGC also noted, however, that the agreements could be deemed to be futures contracts if the dealer or the bank stood ready to repurchase the metals at the prevailing market price upon the customer's demand.[306] That such an element would provide a means of price speculation in the underlying metals and therefore would operate in a manner substantially similar to futures contracts apparently was the basis for this conclusion.

Finally, the OGC addressed whether the Model State Commodity Code, which the North American Securities Administrators Association (NASAA) recently had adopted as part of NASAA's effort to prevent off-exchange commodities abuses, would apply to the proposed transactions.[307] The OGC concluded that the Model Code also would be unlikely to prohibit the agreements because the bank would be able to avail itself of an exemption for financial institutions' sales of commodity contracts and delivery would be made and accepted within two business days of the sale date in all

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305. CFTC Interpretive Letter No. 85-2, [1984-1986 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 22,673, at 30,856 (August 6, 1985).

306. *Id.* As noted above, the CEA grants the CFTC exclusive jurisdiction over transactions in futures contracts and commodity options. Nevertheless, Congress amended the CEA in 1978, to permit the states to bring *parens patriae* suits in federal court under the CEA for violations committed within their borders. 7 U.S.C. § 13(a)-2 (1982). *See generally* Lower, *State Enforcement of the Commodity Exchange Act*, 27 EMORY L.J. 1057 (1978). Moreover, in the 1982 amendments to the CEA, Congress included an "open season" provision, which specifically provides that state criminal proceedings are not preempted by the CEA, and that state laws in any form may be applied to off-exchange instruments. 7 U.S.C. § 16(e) (1982); S. REP. No. 384, 97th Cong., 2d Sess. 27 (1982). *See also* Horwitz & Markham, *supra* note 4, at 78. As a result, the states now not only may enforce the CEA with respect to conduct within their jurisdictions, but also may enforce state law if the activity involves prohibited off-exchange transactions. The Model Code was promulgated pursuant to this "open season" provision.

307. CFTC Interpretive Letter No. 85-2, [1984-1986 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 22,673, at 30,857 (Aug. 6, 1985). NASAA adopted the Model Code in connection with a coordinated effort among the federal and state regulatory agencies to prevent recurrences of the serious off-exchange precious metals trading abuses that occurred in 1983-1984. *See* Gilberg, *supra* note 9. The two most celebrated scandals, involving Bullion Reserve of North America and The International Gold Bullion Exchange, had heen perpetrated by persons ostensibly unregulated by any federal or state agency; and the enactment of the Model Code was intended in part to bring these dealers within the scope of some regulatory scheme. The Model Code essentially prohibits the offer and sale of any off-exchange contract for the purchase or sale of commodities, primarily for investment or speculation and not for the acquisition or disposition of ownership of the underlying commodities. Nevertheless, the Model Code exempts from this proscription offers or sales by otherwise regulated entities. The Model Code also exempts a number of specific types of transactions. *See* NASAA Model State Commodity Code, [1984-1986 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 22,568, at 30,451 (Apr. 5, 1985).

transactions.[308] In this regard, the OGC pointed out that the Model Code deemed confirmations or transfers of documents of title to constitute good delivery.[309]

The status of financing arrangements under the commodities laws, therefore, appears relatively clear at this point. If delivery in some acceptable form occurs within two business days (or perhaps within some longer reasonable period of time), the CFTC is not likely to deem the instruments futures or leverage contracts. On the other hand, arrangements in which such delivery does not occur creates potential for abuse, particularly when a dealer has the right to rehypothecate metals purchased by a customer. Under such circumstances, the same metals might be sold and actually "delivered" to a number of different customers, thus creating the possibility that no metals will be available if one customer requests physical delivery or sells the metals to a third party.

With respect to the securities laws, purchases and sales of precious metals, without more, apparently do not involve the offer and sale of a security, even if a dealer finances the transaction. The SEC has contended, and several courts have held, that a security may be created when a broker or dealer simply pools the funds of several customers for trading conducted in the dealer's own name on a discretionary basis.[310] The pooling of several customers' funds for discretionary trading was held in those instances to satisfy the *Howey* common enterprise test because the profit or loss of each customer was intertwined with the profit or loss of other customers.[311]

Conversely, in a number of no-action letters, the SEC staff has stated that programs which brokerage firms or metals dealers operate involving purchases and sales of precious metals do not require Securities Act registration when title to the metals actually passes to the customer, either through physical delivery or bulk segrega-

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308. CFTC Interpretive Letter No. 85-2, [1984-1986 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 22,673, at 30,857 (Aug. 6, 1985).

309. *Id.*

310. *See, e.g.*, Jenson v. Continental Fin. Corp., 404 F. Supp. 792 (D. Minn. 1975); SEC v. Western Pac. Gold & Silver Exch. Corp., [1974-1975 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 95,064 (D. Nev. January 30, 1975).

311. *See supra* note 310. In *Jenson*, the dealer was granted complete discretion over the customers' funds and used those funds to invest in a pool of metals. Each customer's profit or loss depends upon the success of the dealer's pooled funds investment and was intertwined with the customers' profit or loss. The court found that the individual customer participations constituted securities within the definition of the Securities Act. In *Western Pacific*, customers never acquired title to any metals and only obtained a claim against the firm for payments of money.

tion. In these programs, no investment advice is provided nor discretionary trading authority accepted by the broker or dealer, and the broker or dealer does not undertake to repurchase the metals upon demand.[312] In contrast to the circumstances in the cases cited above, the SEC staff found that the economic benefits to the purchasers were not derived from the seller's or a third party's managerial efforts and that the dealer's functions were no more than ministerial and custodial.[313]

The SEC's most recent definitive statement on the status of precious metals programs under the securities laws was in the testimony of John M. Fedders before the Senate Permanent Subcommittee on Investigations' 1984 hearings on precious metals trading.[314] In those hearings Mr. Fedders, then Director of the SEC's Division of Enforcement, stated that contracts for the purchase or sale of precious metals generally would not be deemed securities if (1) the dealer's functions merely are ministerial, such as providing storage of the metal; (2) the services that the dealer offers are not part of an "investment package," by which the customer simply invests money and receives profits or losses; (3) no "buy-back" plan or other arrangement that gives the dealer shares in the customer's risk exists; and (4) the dealer provides no investment advice and exercises no investment discretion over the customer's account.[315]

Mr. Fedders further testified that financing metals transactions would not in itself result in the characterization of a commercial transaction as a security. To the contrary, Mr. Fedders noted that financing metals transactions essentially is no different from financing purchases of other commodities, which generally have not been regarded as involving the sale of securities:

> The arranging of financing for precious metals transactions would not, in most situations, transform the sales into sales of securities. Actual sales of commodities financed by a bank or the seller would, absent other factors, have little to distinguish them from financed sales of houses or automobiles. Such transactions are financed purchase transactions and not securities.[316]

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312. *See* E.F. Hutton & Co., Inc., SEC No-Action Letter, (Dec. 31, 1974); Drexel Burnham & Co., SEC No-Action Letter (Jan. 2, 1975); Securities Act Release No. 5552, [1974-1975 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 80,037 (Dec. 26, 1974).

313. Securities Act Release No. 5552, [1975-1975 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 80,037 (Dec. 26,1974).

314. Fedders' Testimony, *supra* note 297.

315. *Id.* at 201-202.

316. *Id.* at 202. In a recent case, the SEC alleged that a firm had been engaged in the offer and sale of securities in violation of the Securities Act when the firm permitted cus-

In sum, unless other factors are involved, the purchase and sale of precious metals, even on a financed basis, should not subject agreements between a customer and a broker or dealer to Securities Act registration.

G. *Deferred Pricing Agreements*

As noted, the CEA explicitly sanctions the use of forward contracts that provide for delivery of physical commodities at a future date for reasons of commercial convenience or necessity.[317] Recently, however, many agricultural entities have developed transactions known as "forward pricing" or "deferred pricing" agreements, which allow the purchase price of commodities that will be delivered under a forward contract to be determined some time after the contract date. Under one type of contract, the parties might enter into an agreement that guarantees the producer the price of a specified futures contract plus or minus an agreed upon differential.[318] The producer has the right to set the final price for the commodity between the time at which the contract was entered and a "closing date," which may be the date of delivery or in some instances even a later date. For example, the producer may have a certain amount of time after delivery to elect whether to receive the minimum price specified in the cash contract or the higher price based upon the contract's formula.[319]

In other cases, the agreement may state only that the purchase price will be the price of an identified futures contract at the time of delivery. The purchaser then hedges its obligation through transactions in futures contracts or through other means. At the delivery time (which in some cases may be selected by the producer), the price is calculated according to the contract's formula, delivery is made, and the price is paid.[320]

In an interpretive release, the CFTC's Office of General Coun-

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tomers to prepay purchases of a given quantity of gold coins at a fixed price. Because the customer could not be assured that the offeror would be able to deliver the purchased gold if prices increased prior to delivery, the SEC contended that the purchase was really an investment in the entity. The Ninth Circuit rejected the SEC's argument and held that the instruments were not securities. SEC v. Belmont Reid & Co., Inc. 794 F.2d 1388 (9th Cir. 1986).

317. 7 U.S.C. § 2 (1982 & Supp. III 1985). *See supra* notes 18-28 and accompanying text.

318. Characteristics Distinguishing Cash and Forward Contracts and "Trade" Options, 50 Fed. Reg. 39,656 (Sept. 30, 1985).

319. *Id.* at 39,660.

320. *Id.*

sel has stated that these transactions do not violate the CEA's prohibitions on futures and options trading if delivery in fact occurs in all instances, absent crop failure or some other natural disaster that renders the commodity unavailable.[321] The OGC stated in that release that these transactions fall within the "forward contract" exemption to the off-exchange futures contracts prohibition because they occur only in commercial contexts; delivery is intended and in fact virtually always occurs, and if delivery is delayed, it is delayed solely on the basis of the parties' commercial needs. Moreover, the OGC stated that the contracts ordinarily are not standardized and involve no margin or other payments.[322]

The OGC also stated that such agreements would not run afoul of the CEA's options ban, despite the option-type elements with respect to price.[323] In the OGC's view, the principal factor is that the transactions do not include an option on delivery. To the contrary, each party's delivery obligation is fixed and cannot be permitted to lapse. Delivery therefore will occur in all instances, except when the commodities being purchased have been destroyed by natural causes.[324]

The more difficult case, however, may be when a third party, not party to the delivery obligation, provides the price protection available under a deferred or forward pricing agreement. In this arrangement, another agricultural entity, a brokerage firm, or similar party agrees to pay or receive from the purchaser or seller the difference between a stated price and a formula price that ordinarily is based upon an identified futures contract. The third party then hedges its own obligations through the trading of futures, options, or some combination of the two. These transactions could be structured in a number of ways. The purchaser could offer the seller a minimum price guarantee like those described above and enter into an offsetting transaction with a third party that would require the third party to make payments to the purchaser in amounts roughly equal to those the purchaser must make to the seller. These contracts arguably do not fall within the OGC's interpretive release because the third party making or receiving payments is not making or receiving delivery of physical commodities.

321. *Id.* The release primarily addressed the applicability of the "trade option" exemption, discussed above, to "hybrid" contracts, which combine elements of futures, forwards, and options.

322. *Id.*

323. *Id.*

324. *Id.*

The better argument, however, appears to be that the transaction still is a bona fide forward contract because delivery will occur in virtually all instances, with a third party facilitating the transaction through a price protection mechanism. Indeed, the terms of such contracts are unlikely in any event to be standardized, and rarely, if ever, will margin payments be involved, although there may be a one-time fee paid up front that clearly is analogous to an option premium. Further, provided that the party "purchasing" the protection is not permitted to settle the contract through offset or liquidation, the contract does not provide a vehicle for price speculation apart from actual delivery commitments.

In fact, in one instance the CFTC's OGC stated that an insurance company offering price protection to farmers it insured did not violate the CEA's prohibitions on off-exchange futures and options contracts.[325] The company stated that the offered contracts would permit a farmer to select a "guaranteed price" for the sale of its crops at a future date.[326] In return for the company's undertaking to pay the farmer at the time of sale the difference between the price actually received and the guaranteed price, the farmer would pay a premium.[327] The OGC concluded that it would not recommend enforcement action against the insurance company if the company submitted to all applicable state insurance regulatory requirements and the product was offered only to existing insurance customers.[328]

In a subsequent no-action letter, OGC concluded that a hedg-

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325. CFTC Interpretative Letter No. 86-1, [1984-1986 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 22,920 (May 20, 1985).

326. *Id.* Specifically, the no-action letter described the program as follows:

> At planting time, the farmer would select a guaranteed price per bushel from among the price guarantee levels offered by [the company]. You state that the "highest price guarantee level will be similar to the price the farmer could obtain from the local elevator" if the farmer were to enter into a forward contract for delivery of the crop at harvest time. The farmer would also elect whether to insure 50, 75 or 90 per cent of either the "crop yield level" which is derived from the "base yield" established for the farmer's location or of the farmer's average actual production history filed with the Agricultural Stabilization and Conservation Service of the U.S. Department of Agriculture.

Id.

327. *Id.* The premium was determined by multiplying four factors: (1) The percentage of the crop covered; (2) the number of acres insured; (3) the premium rate per bushel; and (4) the farmer's share or interest in the crop. In addition, the premium included the company's hedging costs, operating and administrative costs, profit margins, premium taxes, and commissions to insurance agents.

328. *Id.* The company also represented that it intended to apply to the state insurance authorities to offer and sell the price protection insurance.

ing service operated by an export trading company would not result in a violation of the CEA's ban on the offer and sale of off-exchange futures and options.[329] The export trading company proposed to extend lines of credit to foreign commercial entities in order to finance their purchases and sales of physical commodities. Furthermore, the lines of credit would enable the export trading company to enter into forward contracts with such entities and to assure them of a purchase or sale price fixed in their home currency.[330] By doing so, the export trading company would thereby protect the other party against the risks of both currency and price fluctuation. The export trading company proposed to cover its own exposure under such contracts through the purchase and sale of exchange traded futures and options.[331]

In granting the request for a no-action position, the OGC noted that the service would be available only to commercial entities and not to members of the general public and that it would be offered only if the Federal Reserve Board approved.[332] In addition, the letter requesting a no-action position had represented that a majority of the transactions (approximately seventy-five percent) would involve either contracts on commodities with respect to which no futures contracts are traded or contracts on commodities slightly different from the commodities on which exchange traded futures contracts are available.[333]

In each of these contexts, therefore, the OGC expressly permitted a third party with no connection to the underlying transaction in physical commodities to provide price protection on behalf of another party. In each case the OGC apparently relied primarily on the fact that the offering entity was subject to regulation by another regulatory authority (insurance regulators in the first instance, the Federal Reserve Board in the second) and that transactions would not be available to members of the general public.

329. CFTC Office of General Counsel, No-Action Letter No. 86-5, 2 Comm. Fut. L. Rep. (CCH) ¶ 23,227 (June 17, 1986).

330. *Id.*

331. *Id.*

332. *Id.*

333. *Id.* Shortly after the OGC's issuance of the no-action letter, the Chicago Board of Trade and the Chicago Mercantile Exchange took the unprecedented action of filing a petition with the CFTC to have the no-action letter revoked, on the ground that the letter exceeded the CFTC's authority and that the CEA mandates that futures trading be conducted on exchanges. *In the Matter of the June 17, 1986 OGC No-Action Letter*, Chicago Board of Trade and Chicago Mercantile Exchange's Petition for Suspension and Revocation, August 4, 1986.

Significantly, the OGC in so doing relegated the instrument's nature to secondary importance and relied more heavily on the status of the offeror and purchaser. Whether these precedents indicate a movement away from the traditional *Stovall* analysis of financial instruments toward a greater permissiveness, at least in the commercial context, remains to be seen.

In any event, however, the nature of the instruments offered in these two instances, when viewed apart from the parties to and purposes of the transaction, clearly bears some similarity to an exchange traded futures contract or option. The contracts themselves may not result in actual delivery between the two contracting parties (although one party ordinarily makes or receives delivery to or from another counterparty under a separate contract), and they may be traded on the basis of margin, premiums, or similar types of deposits. Nevertheless, the contracts' terms are not standardized, but are customized to the particular needs of the counterparty. The pricing and collateralization of the instruments often operate distinctly from futures margins or options premiums. Moreover, the transactions are almost always available only to commercial entities utilizing the instruments in connection with their trade or business. As a result, little or no opportunity for speculation exists. Under such circumstances, the OGC's conclusion is supportable under the *Stovall* test as well.

Indeed, these price protection agreements are virtually identical to the interest rate ceiling programs described above, distinguished only by the substitution of agricultural commodities for interest rates. As noted, in that context the CFTC has taken largely a "hands off" policy, apparently based upon its belief that such transactions occur exclusively between financial institutions. These entities as well as the underlying "commodity"—interest rates—are subject to other authorities' regulatory jurisdiction. With respect to agricultural commodities, this rationale is not accurate. Nevertheless, for the same reasons that parties with interest rate risks enter into ceiling agreements, only institutional participants, such as agricultural business concerns, will enter into these price protection programs in the agricultural area. In either case, there are few, if any, legal or policy justifications for an assertion of CFTC jurisdiction.

Finally, deferred pricing agreements or price protection plans raise the same issues under the securities laws as the interest rate products discussed above. In these cases as well, it is unlikely that a *Howey* common enterprise will be found. The offeror's obligations very well may be structured in the form of a note or evidence of indebtedness, although a strong argument can be made that the commercial purpose test will almost always be met, given the institutional nature of the participants and their reasons for entering into the transactions. If not, it would be permissible to offer the product only pursuant to a Securities Act registration statement or an appropriate exemption from registration. When offers are made only to commercial entities using the contracts in connection with their trade or business, it is likely that many, or even most, offerees will satisfy the "accredited investor" test under SEC Regulation D. Nevertheless, many potential purchasers of such products very well may be small enterprises or even individuals, and a private placement approach itself may be difficult. As a result, it is possible that a firm seeking to offer such instruments will be required to limit its potential customer base to those individuals or entities who are accredited investors.

Once again, however, a finding that a particular type of instrument is a security could create problems under the ICA even if Securities Act registration is not required. Specifically, an entity deriving a substantial portion of its income from such instruments could cross the threshold into the "inadvertent investment company" rubric described above. This result could have serious consequences for the entity's ability to operate, regardless of whether the individual securities offered to customers are required to be registered under the Securities Act.

VI. Conclusions and Recommendations

Perhaps the only clear conclusion from the foregoing is that few if any coherent guidelines exist for analyzing new financial instruments. Nevertheless, several common threads run through the agencies' analyses of these instruments. First, and perhaps foremost, the SEC, under Regulation D and the Securities Act, and the CFTC, under its long-standing interpretation of the CEA, seem less likely to challenge the offer and sale of a product that is marketed solely to institutions and not to members of the general public. The principal statutory mandate of each agency is public protection, and each agency views its primary function as reducing the potential for defrauding public customers. Although fraud can and does occur on organized exchanges, the SEC and CFTC are particularly sensitive to activities occurring in the over-the-counter markets, which are not subject to the same extensive regulatory and self-regulatory oversight as exchange environments. Off-exchange transactions with members of the general public, therefore, almost certainly will invoke SEC or CFTC scrutiny if they arguably involve futures, options, or securities.

Second, the SEC and CFTC each view certain types of instruments as peculiarly within or outside their respective jurisdictions, depending upon the nature of the underlying commodity or security. For example, a contract for the purchase or sale of a security or index of securities, including exempt securities, undoubtedly will concern the SEC to a greater extent than will agreements regarding crops or livestock. This concern exists because the former contracts arguably affect the markets in the underlying securities, which are principally regulated by the SEC, while the latter contracts will have little or no impact on those markets. In the case of forward contracts on agricultural commodities or commodity-backed bonds, therefore, the SEC's interest will be limited to determining whether the product itself is a security and will not extend to any potential repercussions on related markets.

Conversely, the CFTC is less likely to express concern over contracts relating to interest rates or government securities than those involving agricultural commodities. This position stems from the CFTC's historical roots as a regulator of contracts only on such commodities and from the Treasury Amendment; indeed, the Commodity Exchange Authority, the predecessor agency to the CFTC, was a division of the Department of Agriculture. Because the growth of financial futures still is a relatively recent phenomenon, the CFTC has not yet begun to view such instruments as lying at the core of its regulatory mandate, despite the dramatic growth of these markets and their present magnitude. This posture, however, is somewhat in confiict with the CFTC's long-standing position, discussed above in connection with the SEC-CFTC jurisdictional conflict and the 1978 and 1982 legislation, that it is the nature of the derivative instrument, not the underlying good or right, that determines jurisdiction.

Third, both the SEC and CFTC appear more likely to find that a given instrument is within their jurisdiction if, under a functional analysis, the instrument operates in the same manner as a security, futures contract, or option and is marketed as an investment or a vehicle for price speculation. For instance, when a particular transaction exhibits certain elements of a security and is entered into for investment purposes, the SEC very well may conclude that the transaction is subject to Securities Act registration.[334] Similarly, a forward delivery-type contract that serves the economic purpose of an exchange traded futures contract—it may be used to hedge or speculate against commodity prices—makes CFTC action more likely.

In part, this response appears to be based upon the complexity of many of the instruments being offered today and the definitional ambiguities in the law. Under such circumstances, the agencies may find it necessary to look to the function of a product to determine its status. In addition, the agencies' approach derives from the broad remedial nature of their governing statutes and the judicial mandate to rely upon the "economic realities" of a given transaction in ascertaining jurisdiction. Viewed in this light, both the SEC and CFTC believe themselves presumptively bound to address products marketed and operating as investments, unless it can be demonstrated that the instruments do not constitute securities or futures.

Although these and other conclusions may be drawn from SEC and CFTC precedent and informal practice in the area of new products, in many instances it remains the case that prospective guidance that is sufficient to allow an institution to offer a particular instrument without first receiving some type of SEC or CFTC clearance simply cannot be obtained. Furthermore, the question of which of the two agencies has jurisdiction over a specific product is very often itself unclear, and even those entities sincerely interested in obtaining any necessary regulatory clearances may be unsure of which agency to approach. In some cases, a firm may receive SEC clearance only to discover that a CFTC problem that has not been addressed still prevents marketing the product.

Moreover, the lack of prospective standards in this area creates serious problems not only for financial institutions, but also for the regulators themselves. The former cannot be certain of their ability to offer specific types of instruments without preclearance; nevertheless, many entities simply may proceed to market new instruments without such approval, as many have done in numerous instances. In that event, the staffs of the SEC and CFTC find themselves faced with a *fait accompli* because the markets simply will be too large and too well organized to permit regulatory intervention in the absence of a major battle between

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334. *See, e.g.*, 51 Fed. Reg. 20,254 (June 4, 1986). In addressing the applicability of the Securities Act to certain annuity contracts, the SEC stated that one of the criteria relevant to its determination was the manner in which the instruments would he *primarily* marketed.

industry and regulators. This conflict in fact has occurred in several cases, most notably the CFTC's recent attempt to assert jurisdiction over the interbank currency market, as described above.

Accordingly, the SEC and the CFTC must develop some objective standards that will allow the regulators as well as the regulated to implement longer term strategies with at least some assurance regarding the current state of the law. Toward this end, it appears that the agencies should take a number of steps.

First, the SEC and CFTC should enter into consultations to construct a more coordinated approach to off-exchange instrument regulation, along the lines of the Shad-Johnson Accord, delineating the regulatory responsibilities of each agency in the off-exchange area. The central element of this approach should be recognition by each of the agencies that their respective spheres of jurisdiction do not depend solely on the status of a derivative instrument, but also on the nature of the underlying good or article.

Initially, the agencies should make clear that derivative instruments on agricultural commodities or other nonsecurities goods and services will be within the exclusive jurisdiction of the CFTC, regardless of whether the derivatives themselves arguably constitute securities. Although this approach would depart from prior SEC statements, the SEC has not as a practical matter involved itself in products based on traditional commodities, such as metals or crops. This step, therefore, would formalize prior practice and establish clear guidance about the locus of regulatory responsibility. In addition, through ongoing consultations with the CFTC, the SEC could assure that such products would not be offered or sold in a manner that would violate the federal securities laws.

The agencies then should state that the SEC will regulate primarily derivative instruments on securities or indexes of securities, unless such instruments constitute futures contracts based on the criteria discussed below. In instances when concurrent jurisdiction would exist, the agencies could establish a consultative mechanism to insure that issuers will not require separate approvals from each agency, which might impose conflicting obligations. The agencies should not, however, provide the SEC with exclusive jurisdiction over derivatives on securities because this would contravene the CEA's explicit grant to the CFTC of exclusive jurisdiction over futures on all goods and articles.

Second, both the SEC and CFTC should issue guidelines governing trading in off-exchange instruments within their respective spheres of authority. The SEC, for example, could state that products within its jurisdiction will be fully subject to the Securities Act, the ICA, and the other federal securities statutes, unless an appropriate exemption is available. This policy would not require any revision of the *Howey* test; it simply articulates the *Howey* test's application to new financial instruments, along the lines of the discussion above regarding derivatives on exempt securities. Specifically, the SEC could state that the pooling of investors' funds (horizontal commonality) will continue to raise the presumption that a security has been created. When this pooling is absent, however, a presumption could be raised that the instrument is not a security, unless the instrument otherwise represents an investment in the issuer. Products involving direct interests in exempt securities as well as derivatives based on physical commodities would be excluded, and the SEC could focus on a more functional definition.

For its part, the CFTC should undertake an "updating" of the definition of a futures contract to reflect the types of off-exchange instruments available today, recognizing that the distinctions between forward contracts and futures contracts in existence in 1974 are no longer valid. Any such revision of the definition should be based upon three considerations: (1) the presence of standardized terms should not be dispositive, unless individually negotiated, customized transactions are precluded and transactions can be entered into by smaller traders without a commercial purpose; (2) the margining of a transaction also should not be dispositive, unless it is margined or collateralized solely on the value of the underlying commodities and at levels low enough to be available to small traders with no commercial purpose, and collateral deposited on the basis of an individual credit analysis should not be treated as a futures margin; and (3) the CFTC should not place undue emphasis on delivery, but rather should focus on whether delivery is required, whether the parties have the financial and physical capacity to make and receive delivery, and, more generally, whether the transaction occurs in the context of deliveries of physical commodities or is primarily a vehicle for hedging or speculation. This would serve to bring the regulatory approach more into line with market realities and would mitigate or eliminate many of the problems recently encountered.

Finally, the agencies should identify categories of permissible offerees with respect to new financial instruments in order to assure public protection. In the case of the SEC, of course, the existing Regulation D standard likely will be adequate in most instances. Nevertheless, as noted, with respect to products arguably constituting "evidences of indebtedness," the SEC should seek to delineate those "commercial purposes" that would remove the instrument from the definition of a security.

The CFTC should also adopt an "accredited investor" approach to regulation of permissible off-exchange instruments, which would permit offers and sales thereof to be made to financial institutions, commercial entities trading for hedging or other business-related reasons, professional traders, and individuals meeting minimum net worth, income, or transaction size specifications. With respect to the second of these categories, the CFTC should state clearly that hedgers, whether entities or individuals, are among those authorized to enter into permissible off-exchange instruments and should employ a definition broader than the "*bona fide* hedge" definition in the Commission's regulations. Persons entering into off-exchange transactions for legitimate business reasons should be granted wider latitude as to the scope of permissible activities, since speculation and abuse are less likely to occur and the transactions may be more necessary to the effectuation of a business purpose. The CFTC also should state that substantive CEA regulation will not be imposed when adequate public protections, such as an effective SEC registration, are already in place.

The SEC and CFTC must begin to recognize and respond appropriately to the dramatic changes that have occurred in the markets within their jurisdiction over the past several years. The most pressing need in the area of off-exchange instruments is an acknowledgement that the over-the-counter "upstairs" market among institutional investors is distinct in almost every respect from the public "retail" market. The former market should be regulated in a separate manner. The agencies' goal in this area clearly should be to allow the maximum flexibility possible to legitimate business enterprises, consistent with public protection, and to refrain from attempts at regulating markets in which no problems have arisen. Only at that point can the agencies begin to adapt the existing regulatory structures to current market realities and needs.