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THE COMMODITY EXCHANGE MONOPOLY—REFORM IS NEEDED

Jerry W. Markham*

Introduction

In theory, the commodity futures markets are the essence of competition.[1] All orders are required to be exposed to trading pits where traders vie competitively and aggressively to assure the best possible execution price.[2] On the surface, as observed from the exchange galleries or on television, the exchanges do appear to be highly competitive, particularly when one views hundreds of traders screaming and gesticulating wildly for orders. The now famous sting operations on the Chicago exchanges in 1989, however, have provided dramatic evidence that a dangerous symbiotic relationship has developed among traders on the floor that is undermining competition and threatening the integrity of the system.[3]

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1. A commodity futures contract allows the buyer (the "long") to purchase, and the seller (the "short") to sell, a specified quantity of an identified commodity at a specified future date. The terms of commodity futures contracts are standardized, which allows the contracts to be offset on the exchanges. Most futures contracts are settled by offset, which is done simply by entering into an opposing order. For example, a short seller may also enter into a long transaction, with the effect that the two obligations effectively cancel each other out. Because futures contracts are standardized, the only negotiable term is the price, which is set by an auction process on the floor of the exchanges. Delivery may be required on futures contracts, but some futures contracts provide only for cash delivery. *See* Katara v. D.E. Jones Commodities, Inc., 835 F.2d 966, 967 (2d Cir. 1987); Chicago Bd. of Trade, The Commodity Trading Manual 12-13 (1989) [hereinafter Commodity Trading Manual]. For a general discussion of commodity futures trading, see M. Powers, Getting Started In Commodity Futures Trading (1983).

2. *See* 17 C.F.R. § 1.38 (1991) (requiring that commodity futures contracts be executed competitively and openly on exchange floors). As will be discussed below, Section 4 of the Commodity Exchange Act also requires that all commodity futures contracts be executed only on the floors of exchanges that are licensed with the federal government as a "contract market." 7 U.S.C. § 6 (1988).

3. For news reports on the Chicago sting operation, see *FBI Investigation of CME Markets To Continue After Mixed Results*, J. Com., Apr. 24, 1991; Behof, *Life in The Pits Will Never Be The Same*, Bus. Wk., Feb. 6, 1989, at 32; Pauly, *More Shoes Drop in The Pits*, Newsweek, Feb. 6, 1989, at 50; McCormick, *The Sting In The Pits*, Newsweek, Jan. 30, 1989, at 54; Crawford & Gorman, *3rd Merc Trader In Pleas Deal*, Chi. Tribune, Apr. 10, 1991, § 3, at 3, col. 6; Crawford, *Community Service in Trader's Plea Deal*, Chi. Tribune, Mar. 28, 1991, § 3, at 1, col. 5; Stern, *Prosecutors Outline Fraud Case Against Chicago Traders*, Reuters Business Report, Sept. 11, 1990, B.C. Cycle, Nexis; Sanborn, *Have Futures of Traders Hit the Pits?*, Nat'l L.J., June 11, 1990, at 8; Crawford, *Defense Bears Down on Agent in Trader Case*, Chi. Tribune, June 2, 1990, § 2, at 1, col. 6; Shapiro, *F.B.I. Agent Under Attack at Trial*, N.Y. Times, May 11, 1990, D12, col. 5; Risen, *Futures Trial is Simply About Fraud, Jury Told; Commodities: The Prosecutor in Opening Remarks, Says The Three*

When these non-competitive arrangements are coupled with the fact that floor traders enjoy a decided time and place advantage over all persons off the floor, and since by law all orders must come to the floor for execution,[4] the market loses its surface aura of maximum competition. Instead, the exchanges may rightly be viewed as having a statutory monopoly that is undermining competition in the futures industry at the expense of the public. That statutory monopoly should be broken and effective floor trading practices and procedures should be established in order to prevent the type of conduct that was exposed by the Chicago sting operation.

This article will describe the background of futures regulation and the role now being played by futures trading in the financial markets. The article will then discuss and propose reforms that are needed to assure effective regulation. Specifically, Part I of the article will discuss the present regulatory scheme under the Commodity Exchange Act.[5] This part includes a discussion of the regulatory background of futures trading, and it describes statutory provisions that are designed to prevent fraud and trading abuses. Part I of the article also discusses some of the numerous regulatory problems and concerns that the government has faced in the futures markets, and it reviews some of the more abusive trading practices that have been uncovered by the Chicago sting operation.

Part II of the article focuses on a core provision in the Commodity Exchange Act that requires futures instruments to be traded on licensed "contract markets."[6] Part II suggests that the solution to many of the

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Defendants Are Common Thieves, The Defense Will State Its Case Today, L.A. Times, May 10, 1990, D2, col. 3; Shapiro, *U.S. Opens Case Against 3 Futures Traders*, N.Y. Times, May 10, 1990, D18, col. 4; Eichenwald, *Business and the Law; Commodity Charges Wide Use of Racketeering Statute*, N.Y. Times, Aug. 7, 1989, at D1, col. 1; *The Chicago Indictments*, Wash. Post, Aug. 5, 1989, at A16, col. 1; Hargreaves, *Agents Posed as Traders in Their Hunt for Evidence*, Fin. Times, Mar. 8, 1989, Survey, at IV; Marx, *Only Thin Coverage at F.B.I. Futures Probe*, Chi. Tribune, Feb. 7, 1989, § 1, at 1, col. 2; Horrock, *U.S. Widens Probe of Trading*, Chi. Tribune, Feb. 1, 1989, § 1, at 1, col. 2; *F.B.I. Commodities 'Sting': Fast Money, Secret Lives*, N.Y. Times, Jan. 30, 1989, at A1, col. 4; Drew & O'Brien, *2 Agents Linger, Listening At Exchanges*, Chi. Tribune, Jan. 26, 1989, § 1, at 1, col. 5; Jouzatis & Gaines, *Trading Probe Intensifies; 200 Subpoenaes Are Issued*, Chi. Tribune, Jan. 25, 1989, § 1, at 1, col. 4; Berg, *Commodity Case Seen Expanding*, N.Y. Times, Jan. 24, 1989, at D1, col. 6; Burton & Crawford, *Farm Firm's Complaint Led to Probe*, Chi. Tribune, Jan. 22, 1989, § 1, at 1, col. 1; Gunset & Cohen, *Probe Shatters Exchanges' Club Atmosphere*, Chi. Tribune, Jan. 22, 1989, § 1, at 14, col. 1; Eichenwald, *FBI Intensifying Commodity Inquiry on Chicago Trades*, N.Y. Times, Jan. 21, 1989, at 1, col. 1; Coll & Marcus, *Undercover Probe Targets Chicago Exchanges*, Wash. Post, Jan. 20, 1989, at A1, col. 4; Drew & Crawford, *How FBI Worked Trader Sting*, Chi. Tribune, Jan. 20, 1989, § 1, at 1, col. 2; Drew & Crawford, *FBI Tape Key to Fraud Investigation*, Chi. Tribune, Jan. 19, 1989, § 1, at 1, col. 6.

A book has also been published on the Chicago Sting Operation. *See* D. GREISING & L. MORSE, BROKERS, BAGMEN AND MOLES—FRAUD AND CORRUPTION IN THE CHICAGO FUTURES MARKETS (1991) [hereinafter BROKERS AND BAGMEN].

4. 7 U.S.C. § 6 (1988).

5. 7 U.S.C. § 1-26 (1988).

6. *See* 7 U.S.C. § 6 (1988).

present regulatory shortcomings is to loosen this statutory monopoly so that competition may operate more fully. This approach will assure that the marketplace, and not artificial regulatory barriers, determines whether particular commodity interests are traded on the exchanges. Part II also proposes that public representation be required on the boards of the exchanges as well as their committees so that the power of the exchanges, which has long been used to block regulatory reforms, is diluted.

Part III discusses some other shortcomings in the present regulatory system that have fostered and encouraged the abuses exposed by the Chicago sting operation. This part also addresses some gaps in the Commodity Exchange Act that prevent effective regulation and it proposes reforms in the manner in which futures trading is conducted on the floors of the exchanges so as to assure maximum competition and efficiency.

I. The Present Regulatory Scheme and Its Background

1. Background

Commodity futures trading evolved from the grain marketing problems that arose in the 1800s in the midwest when farmers would bring their grain to market after the harvest. The market would then become so flooded with grain that prices would drop drastically—often to levels far below production and transportation costs. At such time, grain would be dumped in the streets and left to rot. Later, as surpluses were used up, grain shortages would occur and prices would skyrocket. Crop failures and transportation problems compounded this boom and bust cycle. To alleviate these conditions "forward" contracts were developed. These were simply contracts for the delivery of grain at a time specified in the future rather than for immediate delivery. These forward, or "to arrive," contracts helped stabilize the market because farmers could sell their grain in advance for set prices and specified delivery dates. They could then store the grain either in their own facilities, or at local elevators, until the grain was needed. This also stabilized the supply situation for processors and users of the grain.[7]

These forward contracts evolved into futures contracts with standardized terms. That is, the quantity and grade of the commodity and the delivery date became standardized with the only negotiated feature being the price. This permitted traders to offset their contracts with each other, which facilitated negotiations and allowed contracts, in effect, to be resold. This

7. *See* Commodity Trading Manual, *supra* note 1, at 3-4; W. Cronon, Nature's Metropolis: Chicago And The Great West 123-125 (1991); T. Hieronymus, Economics of Futures Trading 72-76 (2d ed. 1980); G. Hoffman, Hedging By Dealing in Grain Futures 15 (1925); J. Markham, The History of Commodity Futures Trading and Its Regulation 3-4 (1987).

standardization also allowed speculation in these contracts. Speculation quickly became widespread.[8]

Abuses soon followed, including efforts to corner the grain markets by maintaining large futures positions coupled with purchases of available deliverable supplies.[9] This required sellers of futures contracts to close their contracts at artificial prices demanded by the cornering party. There was also widespread concern that speculators in Chicago were driving grain prices down to levels below production costs, which created much animosity on the part of populists and members of Congress. As a result, numerous bills were introduced in Congress to regulate grain futures trading.

A related problem involved off-exchange transactions where individuals and brokers engaged in betting on differences in commodity prices. The operation of these so-called "bucket" shops became widespread. Unfortunately, when customers made large gains, the bucket shops often folded up and their customers never received their profits.[10] Efforts were made to stop the bucket shops by labeling such transactions as gambling contracts and a considerable body of case law and numerous state statutes were developed to regulate such trading.[11] These efforts were largely unsuccessful and wagers

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8. *See* COMMODITY TRADING MANUAL, *supra* note 1, at 5; W. CRONON, *supra* note 7, at 125-132; II FEDERAL TRADE COMMISSION REPORT ON THE GRAIN TRADE 108-109 (1920) [hereinafter II REPORT ON GRAIN TRADE]; G. HOFFMAN, FUTURE TRADING UPON ORGANIZED COMMODITY MARKETS IN THE UNITED STATES 18 (1932).

9. *See* Markham, *Manipulation of Commodity Futures Prices—The Unprosecutable Crime*, 8 YALE J. ON REG. 281, 289-290 (1991).

10. *See* Board of Trade v. Christie Grain & Stock Co., 198 U.S. 243 (1905); A. FABIAN, CARD SHARPS, DREAM BOOKS & BUCKET SHOPS (1990); II REPORT ON GRAIN TRADE, *supra* note 8, at 121-128; 5 FEDERAL TRADE COMMISSION REPORT ON THE GRAIN TRADE 329 (1924) [hereinafter 5 REPORT ON THE GRAIN TRADE]; J. LURIE, THE CHICAGO BOARD OF TRADE, 1859-1905 76-78 (1939); Van Smith, *The Commodity Futures Trading Commission and the Return of the Bucketeers: A Lesson in Regulatory Failure*, 57 N.D.L. REV. 7, 13, n.26 (1981); Note, *Federal Regulation of Commodity Futures Trading*, 60 YALE L.J. 822 (1951). Although the origin of the term bucket-shop is obscure, one author has determined that it:

> was first used in the late [18] '70s, but it is very evident that it was coined in London as many as fifty years ago, when it had absolutely no reference to any species of speculation or gambling. It appears that beer swillers from the East Side (London) went from street to street with a bucket, draining every keg they came across and picking up cast-off cigar butts. Arriving at a den, they gathered for social amusement around a table and passed the bucket as a loving cup, each taking a "pull" as it came his way. In the interval there were smoking and rough jokes. The den soon came to be called a bucketshop. Later on the term was applied, both in England and the United States, as a byword of reproach, to small places where grain and stock deals were counterfeited.

J. HILL, GOLD BRICKS OF SPECULATION 39 (1904).

11. *See generally* T. DEWEY, A TREATISE ON CONTRACTS FOR FUTURE DELIVERY AND COMMERCIAL WAGERS INCLUDING OPTIONS, FUTURES AND SHORT SALES (1886); T. DEWEY, LEGISLATION AGAINST SPECULATION AND GAMBLING IN THE FORMS OF TRADE (1905); J. DOS PASSOS, A TREATISE ON THE LAW OF STOCK-BROKERS AND STOCK-EXCHANGES 406-410 (1882); Pratt, *American Contract Law at the Turn of the Century*, 39 S.C.L. REV. 415 (1988); Taylor, *Trading in Commodity Futures—A New Standard of Legality?*, 43 YALE L.J. 63 (1933); Van Smith, *Preventing the Manipulation of Commodity Futures Markets: To Deliver or Not to Deliver?*, 32 HASTINGS L.J. 1569, 1573-1579 (1981).

spread to the oil markets[12] and even to the stock market where traders were allowed to speculate on price changes in the same manner as they could speculate in price changes on grain. In *Justh v. Holliday*,[13] for example, a brokerage firm sought to enforce a note against a decedent's estate. The decedent had given the note for losses resulting from his betting on stock price differences. The court concluded that such transactions were unenforceable gambling transactions because the decedent had not purchased or received title to any stocks. Moreover, the decedent did not have the financial wherewithal to purchase the amount of stocks upon which the difference trading was conducted. This was a victory for the decedent's estate, but the decedent himself, General George Armstrong Custer, lost an even bigger gamble at the Little Bighorn shortly after the issuance of the note in question.[14]

Legislative efforts to regulate futures trading both on and off the exchanges were unsuccessful until 1921 when the Futures Trading Act of 1921 was adopted.[15] This statute, which was based on the taxation powers of Congress, imposed a prohibitive tax on futures transactions that were not conducted on an exchange licensed by the federal government. Exchanges so licensed were also required to prevent manipulation of prices. Although the Supreme Court held that this legislation was an unconstitutional extension of the Congressional taxing power,[16] the next year Congress enacted essentially the same statute under its authority to regulate interstate commerce. This statute, the Grain Futures Act,[17] was upheld by the Supreme Court.[18]

The Grain Futures Act proved to be ineffective in preventing market abuses. To cite one example, the Commodity Exchange Commission, which administered the Act, held that trading practices which appeared to be nearly identical to those exposed in the Chicago sting operation did not fall

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12. Speculation was conducted in so-called oil "certificates" on various oil exchanges in the 1880s, until the Standard Oil Company used its monopoly power to stop their operations. *See* P. GIDDENS, THE EARLY PETROLEUM INDUSTRY 182-183 (1974); D. YERGIN, THE PRIZE, THE EPIC QUEST FOR OIL, MONEY, AND POWER 53 (1991); Barbour, *Sketch of the Pittsburgh Oil Exchanges*, 11 W. PA. HIST. MAG. 127 (1928). The Standard Oil trust destroyed the exchanges because its own existence "depended on the ability of the company to fix oil prices for virtually the entire industry." R. SMITH, THE MONEY WARS, THE RISE AND FALL OF THE GREAT BUYOUT BOOM OF THE 1980s 49 (1990).

13. 13 D.C. (2 Mackey) 346 (1883), *noted in* Pratt, *supra* note 11, at 452, n.125.

14. *See generally* E. CONNELL, THE SON OF THE MORNING STAR, CUSTER AND THE LITTLE BIG HORN (1981). Commodity futures traders continue to defend themselves against charges that they are gamblers. *See* Rogers & Markham, *The Application of West German Statutes to United States Commodity Futures Contracts: An Unnecessary Clash of Policies*, 19 GEO. J.L. & POL'Y INT'L BUS. 273 (1987); Potts & Lippman, *Is This Any Way to Set Oil Prices?*, Wash. Post, Jan. 12, 1991, at A1, col. 4; McMurray, *A Losing Proposition, Futures Trading is Usually a No-Win Game for the Small Investor*, Wall St. J., Oct. 19, 1990, at R4, col. 1.

15. Future Trading Act of 1921, ch. 86, 42 Stat. 187 (1921) (repealed 1922).

16. Hill v. Wallace, 259 U.S. 44, 68 (1922).

17. Grain Futures Act, ch. 369, 42 Stat. 998 (1922).

18. Board of Trade v. Olsen, 262 U.S. 839 (1923).

within the prohibitions against manipulation in the Grain Futures Act. The Commission stated that, while such transactions might be fraudulent, they were not manipulative and, therefore, were not subject to the prohibitions of the Grain Futures Act.[19] The Supreme Court also later held that a party manipulating the markets could not be the subject of disciplinary action by the Secretary of Agriculture unless disciplinary action was imposed before the manipulation had been completed.[20] Legal processes, however, simply did not permit the completion of such an action before a manipulation could be effectuated. Consequently, the Act was effectively gutted.

The stock market crash of 1929 was accompanied by a drastic decline in grain prices and, with the election of Franklin Roosevelt, a presidential call went out for legislation concerning both securities and commodities.[21] Much of the securities legislation was adopted before 1934—*i.e.*, the Securities Act of 1933[22] and the Securities Exchange Act of 1934.[23] Commodities legislation, however, was not enacted until 1936. It also took a much different route from that of the securities legislation, which was handled by the banking committees. Instead, commodity futures regulation fell within the province of the agricultural committees. The result was the Commodity Exchange Act of 1936.[24]

The Commodity Exchange Act differed in many respects from the securities legislation that was adopted during the New Deal. For example, the Commodity Exchange Act carried forward the concept of the Futures Trading Act that all futures contracts must be traded on a licensed exchange called a "contract market."[25] Unlike the securities industry, no over-the-counter trading is permitted in futures contracts. Another concept that was carried forward in the Commodity Exchange Act was that of a regulatory oversight body called the Commodity Exchange Commission. Rather than being an independent federal agency, such as the SEC, the Commodity Exchange Commission was composed of the Secretaries of the Departments of Agriculture and Commerce and the Attorney General of the United States. Day-to-day regulation of the statute was given to the Secretary of Agriculture who assigned this duty to an agency within the department, the Commodity Exchange Authority (CEA).[26]

The Commodity Exchange Act prohibited manipulation.[27] However, unlike the federal securities laws,[28] the Act did not identify particular

19. Secretary of Agriculture v. Massey, Docket Nos. 2-3 (G.F.A. 1933), *noted in Regulation of Commodity Exchanges, Hearing Before the House Committee on Agriculture On H.R. 3009 (Commodity Exchange Act)*, 74th Cong., 1st Sess. 69-72 (1935).

20. Wallace v. Cutten, 298 U.S. 229, 236-37 (1936).

21. *See* H.R. Rep. No. 421, 74th Cong., 1st Sess. 2 (1935).

22. 15 U.S.C. §§ 77a-77aa (1988).

23. 15 U.S.C. §§ 78a-78ll (1988).

24. 7 U.S.C. §§ 1-26 (1988).

25. *See* 7 U.S.C. § 6 (1988).

26. *See* H.R. Rep. No. 975, 93d Cong., 2d Sess. (1974).

27. 7 U.S.C. §§ 7(d), 9, 13(b) (1988).

28. *See* 15 U.S.C. § 78i (1988) (identifying particular practices that constitute manipulation under Securities Exchange Act).

practices that would constitute such conduct, and it did not define what the term manipulation meant. The Commodity Exchange Act prohibited fraud, but only narrowly and in the most convoluted terms.[29] Further, unlike the federal securities laws,[30] the Act did not give a federal regulatory agency authority to adopt rules broadly prohibiting fraud or to define even more specifically fraudulent or manipulative practices that should be prohibited.[31] The Act prohibited specific trading practices such as "wash" sales, "fictitious" trades and "accommodation" trading, but did not define these terms.[32]

The Commodity Exchange Act also imposed registration requirements on brokers on the floors of the exchanges[33]—*i.e.*, on traders who executed customer's orders on the exchanges[34]—but it did not attempt to regulate individuals on the floors who were trading for their own accounts. Brokerage firms were required to register as "futures commission merchants" (FCMs),[35] but little substantive regulation was imposed other than a provision that required customer funds to be maintained as segregated trust accounts.[36] The most substantive regulatory effort was directed at position limits, which precluded speculators from establishing positions larger than those specified by the Secretary of Agriculture.[37] However, these limits were not applied to commercial traders, even though commercial traders have a history of disrupting the markets.[38]

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29. *See* 7 U.S.C. § 6b (1988). As the Second Circuit has stated, "while the intent to outlaw fraud is clear," the statute's "syntactical mess" and its "crabbed" language make "it difficult to answer some basic questions about coverage." Leist v. Simplot, 638 F.2d 283, 322-323 (2d Cir. 1980), *aff'd sub nom.* Merrill Lynch, Pierce, Fenner & Smith v. Curran, 456 U.S. 353 (1982).

30. *See* 15 U.S.C. § 78j(b) (giving broad authority to Securities and Exchange Commission to adopt anti-fraud regulations). It was under this provision that Rule 10b-5, 17 C.F.R. § 10b-5, was adopted. That regulation has been the subject of literally thousands of judicial proceedings. *See generally* 5-5d A. JACOBS, LITIGATION AND PRACTICE UNDER RULE 10B-5 (1990).

31. In 1974, Congress granted the Commodity Futures Trading Commission (CFTC) the authority under the Commodity Exchange Act to promulgate such rules and regulations as in the judgment of the Commission are necessary to accomplish any of the purposes of the Commodity Exchange Act or to implement any of its provisions. *See* 7 U.S.C. § 12a(5) (1988). The CFTC, however, has not often utilized that authority as a broad independent rulemaking authorization. *But see In re* ContiCommodity Services, Inc., 2 Comm. Fut. L. Rep. (CCH) ¶ 25,038, at 37,880, n.15 (C.F.T.C. 1991). Nevertheless, the courts seem willing to hold that this provision gives the CFTC broad rulemaking authority. *See* British American Commodity Options Corp. v. Bagley, 552 F.2d 482, 486 (2d Cir.), *cert. denied*, 434 U.S. 937 (1977); *but see* Business Roundtable v. SEC, 905 F.2d 406 (D.C. Cir. 1990) (rejecting SEC requirement that exchanges adopt one vote one share rule under broad statutory language that authorizes SEC to amend exchange rules).

32. *See* 7 U.S.C. § 6c (1988).

33. *See* 7 U.S.C. § 6e (1988).

34. *See* 7 U.S.C. § 2(a) (1988).

35. 7 U.S.C. § 6d (1988).

36. *See id.*

37. *See* 7 U.S.C. § 6a (1988).

38. *See* Markham, *supra* note 9, at 285-98.

The Commodity Exchange Act had several other inherent weaknesses and limitations. For example, its terms applied only to specified commodities and the continued expansion of commodity futures trading on other commodities required frequent amendments to the statute.[39] Ultimately, as trading expanded to such "world" commodities as coffee, cocoa and sugar, Congress was unable to keep pace with the rapid development of new markets by such piecemeal amendments.[40]

These deficiencies became apparent early in the tenure of the CEA, but Congress declined to act until the 1970s, when a virtual explosion of prices in the commodity markets occurred.[41] This caused much anguish in Congress as consumers sought to lay the blame for these price increases on speculators and abuses in the commodity markets.[42] Failures in so-called "naked" commodity options and other problems led to a Congressional conclusion that it could no longer permit the CEA to act as the regulator under the Commodity Exchange Act.[43] Consequently, Congress adopted the Commodity Futures Trading Commission Act of 1974.[44] Among other things, it created the Commodity Futures Trading Commission (CFTC) and gave it "exclusive" jurisdiction over futures and commodity options trading.[45] This legislation allowed the CFTC to impose civil penalties of up to $100,000 per violation in administrative proceedings.[46] It also authorized the CFTC to seek injunctive relief in the federal courts to prevent violations from occurring[47] and it gave the CFTC the authority to require the exchanges to take emergency actions in the event of manipulations or other emergencies in the markets.[48]

2. *Continued Regulatory Problems and Concerns*

The CFTC was plagued in its early years by serious organizational problems and it faced a number of crises that raised grave concerns as to its ability to regulate the futures markets.[49] For example, the CFTC almost

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39. *See* H.R. REP. No. 975, 93d Cong., 2d Sess. 35 (1974).

40. *See id.* at 82; S. REP. No. 1131, 93d Cong., 2d Sess. 19, 47 (1974).

41. *See* Markham, *supra* note 9, at 328-31.

42. *See, e.g.*, H.R. REP. No. 975, 93d Cong., 2d Sess., 47-48 (1974); 120 CONG. REC. 16,134 (1974) (statement of Sen. Hart); 120 CONG. REC. 2938 (1974) (statement of Rep. Smith); 120 CONG. REC. 2928 (1974) (statement of Rep. Abrams); D. MORGAN, MERCHANTS OF GRAIN 121 (1979) (discussing "Great Grain Robbery" that involved large grain purchases by Soviet Union, causing large price increases in grain).

43. *See* H.R. REP. No. 975, 93d Cong., 2d Sess. 37-38, 48 (1974); 120 CONG. REC. 2928 (statement of Rep. Brown).

44. Pub. L. No. 93-463, 88 Stat. 1389 (1974).

45. *See* 7 U.S.C. § 2(a) (1988).

46. *See* 7 U.S.C. § 9 (1988).

47. *See* 7 U.S.C. § 13a-1 (1988).

48. *See* 7 U.S.C. § 12a(9) (1988).

49. *See Investigative Study on the Commodity Futures Trading Commission; Report to the House Committee on Appropriations by Mr. Whitten for Use by the Subcommittee on Agriculture, Rural Development and Related Agencies*, 95th Cong., 2d Sess. (1978); J. MARKHAM, *supra* note 7, at 97-101.

immediately allowed commodity options trading to commence once again. This trade soon turned into a national scandal when it was discovered that the head of one large firm was actually an escaped felon.[50] In addition, the CFTC faced a debacle in the potatoes futures market when an unprecedented default in 1976 disrupted trading and shook public confidence in the futures markets.[51] Thereafter, the Hunt family in Dallas, Texas made an assault on the soybean market in 1977,[52] which was followed by their involvement in the so-called silver crisis of 1980.[53] In the latter, the Hunts were accused of attempting to corner the entire silver market, a tale that has become as legendary as Jay Gould's attempted corner of the gold market in the 1860s.[54]

The CFTC encountered other difficulties that involved its "exclusive"[55] jurisdiction over futures trading. Early in its existence the CFTC approved the concept of trading futures contracts on GNMA securities. The SEC objected to the CFTC's action, contending that such contracts were within its jurisdiction. The CFTC ignored that objection.[56]

The SEC fought back. The CFTC is subject to a reauthorization or "sunset" provision which periodically requires the Congress to review the CFTC's operations. In the course of the first of the CFTC's sunset hearings in 1978, the SEC attempted to convince Congress that the SEC should be given a portion of the CFTC's jurisdiction, contending that the CFTC was not qualified to regulate trading on financial markets. This effort was unsuccessful.[57]

Thereafter, the SEC authorized the Chicago Board Options Exchange, an exchange regulated by the SEC, to conduct trading in options on GNMA contracts. The Chicago Board of Trade, however, sued and was successful in stopping the SEC from allowing this contract to proceed.[58] In 1982, however, that decision was mooted when the CFTC and the SEC agreed to

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50. *See* Markham & Gilberg, *Stock and Commodity Options—Two Regulatory Approaches and Their Conflicts*, 47 Alb. L. Rev. 741, 763-64 (1983).

51. *See* Strobl v. New York Mercantile Exch., 768 F.2d 22, 23 (2d Cir.), *cert. denied*, 474 U.S. 1006 (1985) (commenting that "[t]his was the largest default in the history of commodities futures trading").

52. *See* CFTC v. Hunt, 591 F.2d 1211 (7th Cir.), *cert. denied*, 442 U.S. 921 (1979).

53. *See* H.R. Rep. No. 565, 97th Cong., 2d Sess., Part I at 61-71 (1982); H.R. Rep. No. 395, 97th Cong., 1st Sess. (1981) ; Report of the Staff of the Securities and Exchange Commission, The Silver Crisis of 1980 (Oct. 1982); CFTC, Report to the Congress in Response to Section 21 of the Commodity Exchange Act (June 1980).

54. *See* H.R. Rep. No. 31, 41st Cong., 2d Sess. (1870); K. Ackerman, The Gold Ring (1988); M. Klein, The Life and Legend of Jay Gould 99-115 (1986).

55. *See* 7 U.S.C. § 2(a) (1988).

56. *See* Securities and Exchange Commission—Commodity Futures Trading Commission Jurisdictional Correspondence [1975-1977 Transfer Binder] Comm. Fut. L. Rep (CCH) ¶ 20,117 (C.F.T.C. 1975).

57. *See* Markham & Gilberg, *supra* note 50, at 774-76; *see also* Young, *A Test of Federal Sunset: Congressional Reauthorization of the Commodity Futures Trading Commission*, 27 Emory L.J. 853 (1978).

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

resolve their differences through an agreement negotiated by their respective chairmen.[59] In brief, the CFTC retained its exclusive jurisdiction over all futures trading and the CFTC assumed exclusive jurisdiction over commodity options trading, except that the SEC assumed jurisdiction over options on currency on national securities exchanges. The CFTC took exclusive jurisdiction over options on futures contracts. The agreement prohibited futures trading on individual securities, and authorized the SEC to allow trading of options on stock indexes on securities exchanges. The SEC also assumed what amounted to a veto power over the CFTC's approval of additional stock index futures contracts.[60]

This peace settlement was short lived. Shortly after Congressional approval of the "Shad-Johnson Accords," the SEC and the CFTC became embroiled in a dispute over the manner in which subindexes of stocks should be approved.[61] While that dispute was resolved, another dispute continued over whether the Federal Reserve Board should be given authority to regulate margins on futures contracts, particularly financial futures contracts. The Federal Reserve Board has regulated margins on securities since the 1930s,[62] and some argued that it should be given similar authority over financial futures. The CFTC resisted and Congress declined to grant that authority.[63] Nevertheless, the controversy continues even today.[64]

These jurisdictional disputes were not the only problems encountered by the CFTC. Indeed, it faced almost yearly crises in the market, including a 1979 coffee manipulation[65] and a market threat in the March 1979 wheat contract that resulted in the CFTC's declaration of a market emergency.[66]

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59. *See* Joint Explanatory Statement of the Securities and Exchange Commission and the Commodity Futures Trading Commission [1980-1982 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 21,332 (C.F.T.C. 1982).

60. *See* Horwitz & Markham, *Sunset on the Commodity Futures Trading Commission: Scene II*, 39 Bus. Law. 67, 72-74 (1983).

61. *See* Kane, *Regulatory Structure in the Futures Markets Jurisdictional Competition Between the SEC, the CFTC, and Other Agencies*, 4 J. Fut. Markets 367, 375 (1984); Ferrara & Chase, *SEC-CFTC Accord: One Year Later, an Uneasy Peace*, Legal Times, Jan. 30, 1984, at 15, col. 1.

62. *See* 15 U.S.C. § 78g(a) (1988). The Federal Reserve Board has, for example, adopted regulations governing margin requirements under Regulation T for credit extended by broker-dealers and Regulation U for bank loans.

63. *See generally* Markham, *Federal Regulation of Margin in the Commodity Futures Industry—History and Theory*, 64 Temple L. Rev. 59 (1991).

64. *See* 137 Cong. Rec. S905 (daily ed. Jan. 14, 1991) (statement of Sen. Leahy); Salwen, *House Panel Votes to Curb Futures Trading*, Wall St. J., Feb. 20, 1991, at C1, col. 3.

65. *See In re* Compania Salvadorena de Cafe, [1982-1984 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 21,886 (C.F.T.C. 1983).

66. *See* Board of Trade v. CFTC, 605 F.2d 1016 (7th Cir. 1979), *cert. denied*, 446 U.S. 928 (1980); *CFTC Reauthorization, Hearings Before the Subcommittee on Conservation, Credit and Rural Development of the House Committee on Agriculture on H.R. 5447*, 97th Cong., 2d Sess. 717-722 (1982); *March Wheat Futures Trading on the Chicago Board of Trade, Hearing Before the Subcommittee on Conservation and Credit of the House Committee on Agriculture*, 96th Cong., 2d Sess. (1979).

Perhaps the gravest crisis of all arose in the form of the October 1987 stock market crash. The extent of the crash has been well documented by a Presidential Commission and numerous governmental and private reports.[67]

The problems encountered in the Stock Market Crash of 1987 were examined by the Brady Commission, which had been appointed by President Reagan to examine the crash and propose reforms.[68] The Commission concluded that intermarket coordination of regulation was needed. The Brady Commission further contended that additional regulatory safeguards should be imposed, including the harmonization of margins between the securities and commodity futures markets. So-called "circuit" breakers were recommended that would, for example, suspend trading when prices reached pre-specified levels.[69] Some of those proposals were adopted but many became the subject of extensive debate between the securities and commodity futures industries.[70] The commodity futures industry sought to stop the SEC from assuming jurisdictional control over the commodities industry and the SEC utilized the problems engendered by the stock market crash to advance once again the position that it should be given regulatory authority over futures contracts on stock indexes. A mini-stock market crash in 1989 renewed the cry for legislative reform.[71]

3. *The Chicago Sting*

Perhaps the most significant regulatory event in the futures industry in recent years was the announcement in early 1989 that the office of the United States Attorney in Chicago had conducted massive undercover operations on the Chicago Mercantile Exchange and the Chicago Board of

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67. *See, e.g.*, DIVISION OF ECONOMIC ANALYSIS AND DIVISION OF TRADING AND MARKETS, CFTC FINAL REPORT ON STOCK INDEX AND CASH MARKET ACTIVITY DURING OCTOBER 1987 TO THE COMMODITY FUTURES TRADING COMMISSION (1988); N. KATZENBACH, AN OVERVIEW OF PROGRAM TRADING AND ITS IMPACT ON CURRENT MARKET PRACTICES (1987); REPORT OF THE PRESIDENTIAL TASK FORCE ON MARKET MECHANISMS (Jan. 8, 1988) [hereinafter TASK FORCE ON MARKET MECHANISMS].

In brief, on October 14, 1987, the "U.S. equity market began the most severe one-week decline in its history." TASK FORCE ON MARKET MECHANISMS, *supra*, at 15. From the morning of Wednesday, October 14 to the following Tuesday, the Dow Jones Industrial Average plummeted almost 700 points. On Black Monday alone, October 19, 1987, the Dow Jones index dropped 508 points. This was twice the percentage drop of 1929's worst day. *Id.* at 15-42. On October 20, 1987, the markets nearly "approached breakdown" because of the almost complete disconnection of the futures and stock markets. *Id.* at 42.

68. *Id.*

69. *Id.*; *see also* Santoni, *Circuit Breakers Make the Market More Volatile*, Wall St. J., Dec. 11, 1990, at A18, col. 3.

70. *See, e.g.*, *Volatile Reactions*, ECONOMIST, July 21, 1990, Survey, at 22; Salwen, *Regulators View Markets' Steep Descent Also As Example of Controls That Work*, Wall St. J., Aug. 27, 1990, at C15, col. 1; Shapiro, *Circuit Breakers, Maybe They Work, Maybe They Don't*, N.Y. Times, July 29, 1990, § 3, at 7, col. 1; Shapiro, *Circuit Breakers Help Index Futures Recover*, N.Y. Times, July 24, 1990, at D6, col. 1.

71. *See generally* Markham, *supra* note 63.

Trade.[72] Disguised FBI agents acted as traders on the exchange floors and tape recorded their conversations with traders. The result was the indictment of forty-six traders, charging hundreds of violations of federal laws. The trials in those actions have not been a complete success for the government.[73]

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72. *See supra* note 3. The Chicago sting operation was "unprecedented" in that FBI agents posed as futures traders for more than a year. *See* McMurray, *Sting Isn't Biting In Commodities Probe*, Wall St. J., Jan. 2, 1991, at R20, col. 1.

73. A total of forty-six individuals were initially indicted and two other traders were later added to that list. *See* McMurray, *Ten Soybean Futures Traders Convicted in Major Victory for U.S. Fraud Inquiry*, Wall St. J., Jan. 10, 1991, at C13, col. 1; McMurray, *supra* note 72, at R20, col. 1. The trials were conducted in three groups. In the first trial, which concerned the Swiss franc pit, the government was not successful in proving many of its charges. *See Futures Trader Mosky Receives a Sentence of 4 Months in Prison*, Wall St. J., July 17, 1991, at C16, col. 6 (reporting that yen trader sentenced to four months, $40,000 fine, $7,000 in restitution and 600 hours of community service); *Ex-Merc Trader Pleads Guilty to One Fraud Count*, Wall St. J., Mar. 20, 1991, at A8, col. 5 (reporting that trader convicted of seven counts of commodity fraud in Swiss franc trial also pled guilty to wire fraud count involving cheating customers of $12.50 to dispose of additional charges); McMurray, *supra* note 72, at R20, col. 1 (explaining that in government's first trial involving Swiss bank traders, two traders were found guilty on a few counts, one was acquitted on certain counts and jury remained deadlocked on two-thirds of over one hundred counts in indictment; that government asserted there would be retrial, but "the probe appears to be petering out"; and that the low number of traders indicted and convicted was "a far cry from the expectations raised by government in mid-January of 1989"). Later, in the soybean pit trial, the government was successful in proving most of its charges. *See* Weir, *CBT Soybean Convictions Could Spur More Investigations, Indictments*, J. Com., Jan. 11, 1991 (reporting that soybean jurors were unswayed by claims that small dollar amounts involved were minor when compared to millions of dollars in leverage provided by futures contracts); *Roundup*, Wash. Post, June 19, 1991, at B2, col. 3 (reporting that soybean trader put on probation fined and ordered to make restitution); *CFTC Files Action Against 10 Traders Convicted In Fraud*, Wall St. J., June 7, 1991, at A7, col. 5 (reporting that CFTC seeking further sanctions in civil proceedings against convicted soybean traders); *Soybean Trader Sentenced to 27 Months In Prison*, Wall St. J., June 3, 1991, at A5, col. 3 (reporting that other soybean traders received probation and one trader was sentenced to 27 months in prison); Taylor, *Soybean Traders at CBOT Receive Stiff Sentences*, Wall St. J., May 28, 1991, at C16, col. 6 (reporting that sentences for convicted soybean traders ranged from over three years to probation); Dishneau, *10 Convicted of Fraud in Commodities Case*, Wash. Post, Jan. 10, 1991, at E3, col. 6 (reporting that 10 traders in soybean pit convicted of racketeering charges and mail or wire fraud; one broker was acquitted of racketeering); McMurray, *Ten Soybean Futures Traders Convicted in Major Victory for U.S. Fraud Inquiry*, Wall St. J., Jan. 10, 1991, at C13, col. 1 (reporting that "[m]ore indictments of futures traders are expected in coming months"). However, the jury in the Japanese yen pit trial announced that they were hung on many of the charges, even after an "Allen dynamite" charge from the judge ordering them to reach some resolution. The same jury also acquitted some of the defendants. *See Two Former Yen Traders Plead Guilty*, Wall St. J., May 2, 1991, at C14, col. 6 (reporting that one trader pled guilty to racketeering charge and another to wire fraud); McMurray, *U.S. Fails to Win Any Convictions Over Yen Trading*, Wall St. J., Mar. 14, 1991, at C11, col. 3 (reporting that verdict in yen pit "was a reversal for the government, which had hoped that its lopsided courtroom victory against 10 soybean futures traders from the Chicago Board of Trade in January had given the probe much needed momentum"); Shapiro, *No Convictions in Trial of Yen Futures Traders*, N.Y. Times, Mar. 14, 1991, at D2, col. 5 (reporting that many Chicago lawyers believed that setback in yen trial would discourage government from pursuing futures cases); *12 Yen Futures Traders Acquitted*

They have, however, shown that illegal after hours trading and petty theft is prevalent on the floors of the commodity exchanges.

The Chicago sting operation also revealed that a widespread, pernicious and symbiotic relationship exists between "floor brokers" who execute customer orders[74] and so-called "locals" who trade for their own accounts.[75] This situation has developed as a result of the fact that the locals and floor brokers enjoy a statutory monopoly over the handling and execution of orders on the exchange floor. As will be described below, the Commodity Exchange Act requires all customer orders to be transmitted to the floor for execution by a floor broker.[76] The customer order flow handled by floor brokers is a prime source of profitability for the locals, who trade for their own accounts. The locals feed off that order flow and they profit even more to the extent they can obtain executions from floor brokers at non-competitive prices.

Floor brokers are willing to provide non-competitive prices because they are susceptible to errors that can cost them thousands of dollars. As shown

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on Most Charges, Wash. Post, Mar. 14, 1991, at B14, col. 1 (discussing verdict in yen pit trial); *see also* Crawford, *Jubilant Merc Chiefs Blast Probe*, Chi. Tribune, Mar. 14, 1991, at 1, col. 2 (reporting that officials of Chicago Mercantile Exchange claim that Chicago sting operation turned up only minor abuses at great cost to government and to defendants); Gorman & Cohen, *Jury Acquits 2, Splits on 10 in Trader Trial*, Chi. Tribune, Mar. 14, 1991, at 1, col. 6 (describing jury deliberations as hostile and reporting that defense attorneys stated that government is likely to indict twenty or thirty additional traders as result of sting operation); McMurray, *More Traders Are Expected to Plead Guilty in Chicago Commodities Probe*, Wall St. J., Jan. 11, 1991, at C13, col. 3 (reporting that several traders in sting operation were "charged with stealing only a few thousand dollars from customers, leading critics to claim that the government was too heavy-handed in its investigation").

74. The Commodity Exchange Act requires individuals executing customer orders to register with the CFTC as floor brokers. 7 U.S.C. § 6e (1988).

75. COMMODITY TRADING MANUAL, *supra* note 1, at 37 (explaining that "locals are traders who 'trade for their own account and speculate on future price movements'"). Floor traders and locals are not required to register with the CFTC. The omission of a registration requirement for floor traders has led to embarrassing incidents in the past when it was discovered that individuals on the floor of the exchanges were convicted felons or had previously abused customer orders. For example, one floor trader had been barred from registration by the CFTC because of a felony conviction, but he continued to trade on an exchange floor as a local, where he engaged in broad scale fraudulent operations. *See* CFTC v. Savage, 611 F.2d 270 (9th Cir. 1979); Savage v. CFTC, 548 F.2d 192 (7th Cir. 1977); BROKERS AND BAGMEN, *supra* note 3, at 96-97, 147-48.

The sting operation in Chicago has given rise to the concern that more substantive regulation should be imposed on floor traders, as well as floor brokers. Proposed legislation would impose a registration requirement on these locals. *See* H.R. 2869, 101st Cong., 1st Sess. § 205 (1989); S. REP. No. 22, 102d Cong., 1st Sess. 14-15 (1991); H.R. REP. No. 236, 101st Cong., 1st Sess. (1989). Proposed regulations may also require registration of floor broker associations so that better surveillance can be maintained over groups of brokers who act together and possibly commit fraud. *Proposed Regulation Requiring Registration of Broker Associations*, 2 Comm. Fut. L. Rep. (CCH) ¶ 24,804 (C.F.T.C. Apr. 11, 1990). However, the Bush Administration is seeking to block that proposal. Comm. Fut. L. Rep. No. 400, pt. 2, Mar. 11, 1991, at 2.

76. 7 U.S.C. § 6 (1988).

by the Chicago sting operation, the locals, in exchange for non-competitive executions, often cover up these errors. The locals are then repaid or prepaid by kickbacks from profits obtained by cheating other customers of the floor broker. Indeed, the Chicago sting operation revealed that floor brokers established elaborate banks or pools with locals that were built up by cheating customers so that floor broker errors could be covered and floor traders allowed to profit without competition.[77]

Government witnesses testified that these trading practices included what were identified as "edges," "leads," "matches," and "trading off" an order.[78] An "edge" seems to be simply a competitive advantage that particular traders are given over other traders because of their willingness to trade in large volume with floor brokers that are executing customer orders. This assists the trader given the edge to buy at the bid and sell at the offering price, or vice versa, thereby profiting on the spread between the bid and ask prices in the pit. The giving of an edge by a floor broker is designed to reward large floor traders who are willing to participate in large volume at or near current market levels and who will cover errors of the broker, as for example, by taking trades that were missed by the floor broker because of chaotic market conditions. Although giving an edge to a large floor trader does not guarantee him a profit and is not viewed to be a payback to cover errors, the floor trader is better assured of a profit because of the competitive advantage he is given. The giving of an edge, therefore, may deliberately exclude competition from the order execution process.[79]

An ever more malignant form of trading is the so-called "lead." Simply stated, a lead is an order given by a floor broker to a floor trader at a price that is slightly different from that existing at other points in the trading pit. This allows the floor trader to accept the customer order and immediately execute an opposite trade with another trader in the pit to obtain a profit. A lead does not guarantee a profit because market conditions

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77. *See* Plea Agreement of Sam Cali, U.S. v. Cali, No. 89CR668-4 at 2-4 (N.D. Ill. plea agreement filed May 1, 1991) (trader admits his role in these activities); BROKERS AND BAGMEN, *supra* note 3, at 204 (discussing "banks" created by "bagmen" who accepted fraudulent trades from floor brokers); Dishneau, *10 Convicted of Fraud in Commodities Case*, Wash. Post, Jan. 10, 1991, at E3, col. 5 (describing allegations concerning "'curb trading,' part of a conspiracy in which brokers illegally passed personal losses from trading errors on to cooperative independent traders in return for guarantees of later profitable trades"); Burns, *Broker's Taped Lament to Agent: Honesty is Costly*, Chi. Sun-Times, Nov. 15, 1990, at 58, col. 1 (reporting that defendant told undercover FBI agent that "busy brokers can't fill customer orders 'honestly and legally' without losing money" and that "brokers are almost expected 'to be able to work out any errors off the deck' of customer orders"); *FBI Agent Says CME Trader on Trial Claimed Open Outcry Not Working*, Knight-Ridder Money Center News 14,995, Oct. 31, 1990 (reporting that trader claimed he needed to make off-market trades to earn living).

78. *See* Testimony of James Nowak at 3393-4004, 3996-97, 4300-01, United States v. Dempsey, 740 F. Supp. 1299 (N.D. Ill. 1990) [hereinafter Nowak Testimony].

79. *See* Nowak Testimony, *supra* note 78, at 4300-01, 4063-64, 4394, 4500; *see also* Testimony of Bradley Ashman at 5574-75, United States v. Dempsey, 740 F. Supp. 1299 (N.D. Ill. 1990) [hereinafter Ashman Testimony].

can change before the order is executed. Nevertheless, it does provide a clear competitive advantage, even greater than an edge, for a floor trader and is intentionally designed to allow the execution of a customer order at a price that is not competitive in the market place. The giving of a lead is often done to repay a trader for prior errors suffered by the floor broker, which were taken into the account of the floor trader and then later paid back by leads.[80]

A third form of fraudulent trading practice exposed by the Chicago sting operation involves so-called "matches." A match occurs when a floor broker gives a buy order and a sale order to a floor trader at disparate prices that provide a profit or a "scratch"—*i.e.*, no profit—to the floor trader. This is done without any exposure to the marketplace. These traders often involve a third party who acts as an intermediary in order to conceal the non-competitive nature of the trades.[81] Matches often occur because floor brokers are too busy to execute all the trades they hold in their "deck."[82] Observing that trades can be matched off before or at the close of trading, the floor broker may simply leave the orders in the deck until market chaos diminishes and they can be matched off with each other in a noncompetitive manner.[83] This assures the floor broker of an execution and allows him to build up his bank or pool with other traders so that he can pay off errors that can not be concealed. A related form of fraud involves trading against an order. This occurs when a floor broker takes the opposite side of his customer's order by using an intermediary broker or brokers.[84]

Another problem dramatized by the FBI sting operation are so-called "curb" trades which are trades conducted after the close of trading.[85] Since such trading is outside trading hours, it constitutes off-exchange trading in violation of the Commodity Exchange Act.[86] Often such trading simply involves floor brokers attempting to fill orders that were missed by mistake or inadvertence during closing sessions, which are often chaotic. In other

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80. *See* Nowak Testimony, *supra* note 78, at 3996-97, 4017, 4122, 4208; *see also* Ashman Testimony, *supra* note 79, at 5754-71.

81. *See* Nowak Testimony, *supra* note 78, at 3393, 4004, 4076-78, 4085.

82. A "deck" is a reference to the outstanding customer orders held by a floor broker on the floor. These orders are limit orders that are to be executed when the market reaches a specified price. The floor broker keeps those limit orders in sequential order so that he can quickly execute them if the market moves in a direction that will cause their execution. *See* T. HIERONYMUS, *supra* note 7, at 53 (describing "deck" of customer orders); *see also* Burns, *Broker's Taped Lament to Agent: Honesty is Costly*, Chicago Sun-Times, Nov. 15, 1990, at 58, col. 1.

83. *See* Nowak Testimony, *supra* note 78, at 4004; BROKERS AND BAGMEN, *supra* note 3, at 146-47.

84. *See* 7 U.S.C. § 6b (1988) (prohibiting trading off an order).

85. *See* Ashman Testimony, *supra* note 79, at 5501-02; Crawford, *Defense Questions U.S. Case in Merc Trader Trial*, Chi. Tribune, Jan. 30, 1991, § 3, at 2, col. 5; Dishneau, *10 Convicted of Fraud in Commodities Case*, Wash. Post, Jan. 10, 1991, at E3, col. 5; Burns, *Witness Tells of Pre-Arranged Trades*, Chi. Sun-Times, Oct. 26, 1990.

86. *See* 7 U.S.C. § 6 (1988); 17 C.F.R. § 1.38 (1991).

instances, curb trading is conducted, often long after the close, in order to cheat customers.[87]

The trading practices revealed by the Chicago sting operation are not new to the commodity futures industry—although their widespread nature and their institutionalization on the exchanges does come as a shock. As noted above, a case brought under the Grain Futures Act charged that similar practices constituted manipulation. There was, however, no fraud prohibition in the Grain Futures Act that could be used to attack such practices.[88] Accordingly, Congress enacted the Commodity Exchange Act in order, among other things, to prohibit such "fictitious" sales, "wash trades," "cross trades," and "accommodation trades."[89] The Act also prohibited brokers from taking the opposite side of customer orders without their permission.[90] Following adoption of that statute, the Commodity Exchange Authority brought a limited number of cases against practices similar to those exposed in the Chicago sting operation.[91] Such cases, however, were not a center piece of the agency's prosecutorial efforts. Indeed, forceful criticism was directed at the Commodity Exchange Authority during consideration of the Commodity Futures Trading Commission Act of 1974 by the Inspector General of the Department of Agriculture because there were insufficient efforts by the Commodity Exchange Authority to determine whether trading was being done openly and competitively in the trading pits. The Inspector General's review found " 'evidence of direct and indirect bucketing of customer orders, accommodation trading, excessive trading between brokers, executing customer and house account orders for the same firm, and matching customer orders.' "[92]

The creation of the CFTC initially resulted in more aggressive prosecution of these trading practices. The CFTC particularly attacked wash trading and other abuses that were done in connection with tax evasion schemes that were widely carried out on the commodity futures markets.[93]

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87. For example, the government indictment in one of the Chicago sting operations charged that "[d]efendant-brokers and accommodating traders would arrange for the traders to trade out of positions for themselves and brokers on the curb as long as one hour and fifteen minutes after the close of the market." Indictment at 20, United States v. Dempsey, 704 F. Supp. 1299 (N.D. Ill. 1990).

88. *See supra* note 19 and accompanying text.

89. *See* 7 U.S.C. § 6c (1988).

90. *See* 7 U.S.C. § 6b (1988).

91. *E.g.*, Laiken v. United States Department of Agriculture, 345 F.2d 784 (2d Cir. 1965); *In re* Gerstenberg, 26 Agric. Dec. 816 (1967); *In re* Platt, 24 Agric. Dec. 93 (1965); *In re* Ritten, 23 Agric. Dec. 747 (1964); *In re* Marks, 22 Agric. Dec. 761 (1963); *In re* Crilly, 20 Agric. Dec. 178, 180-181 (1961); *In re* Bojtek, 7 Agric. Dec. 386 (1948); *In re* Thomas Jordan & Co., 7 Agric. Dec. 381 (1948); *In re* Goldwurm, 7 Agric. Dec. 265 (1948).

92. H.R. Rep. No. 975, 93d Cong., 2d Sess. 46-47 (1974).

93. *See In re* Ratliff v. Commissioner, 865 F.2d 97 (6th Cir. 1989); Landreth v. Commissioner, 859 F.2d 642 (9th Cir. 1988); Herrington v. Commissioner, 854 F.2d 755 (5th Cir. 1988); Forsyth v. Commissioner, 847 F.2d 796 (7th Cir. 1988); Miller v. Commissioner, 836 F.2d 1274 (10th Cir. 1988); Kirchman v. Commissioner, 682 F.2d 1486 (11th Cir. 1986);

The CFTC, however, as will be discussed below, ran into difficulty in identifying whether particular trades were abusive and whether the trades were done competitively. In fact, the CFTC recently issued four opinions concerning tax trading practices that had occurred some ten or more years ago in connection with those tax trading scandals.[94] Those decisions will make prosecution of trading practices such as those exposed by the Chicago sting operation even more difficult.

II. The Exchange Monopoly Should Be Eliminated

The fraud revealed by the Chicago sting operation initially raised widespread consternation in the press.[95] That concern diminished, however,

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DeMartino v. Commissioner, 2 Comm. Fut. L. Rep. (CCH) ¶ 24,372 (2d Cir. 1988); United States v. Winograd, 656 F.2d 279 (7th Cir. 1981); United States v. Turkish, 623 F.2d 769 (2d Cir. 1980), *cert. denied*, 449 U.S. 1077 (1981); Yosha v. Commissioner, 2 Comm. Fut. L. Rep. (CCH) ¶ 24,368 (7th Cir. 1980); Katz v. Commissioner, 2 Comm. Fut. L. Rep. (CCH) ¶ 24,255 (Tax Ct. 1988); *In re* Richardson Securities Inc. [1977-1980 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 20,842 (C.F.T.C. 1979), *aff'd on other grounds*, [1980-1982 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 21,145 (C.F.T.C. 1981); *In re* Richardson Securities Inc., [1977-1980 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 20,810 (C.F.T.C. 1979); *In re* Siegel Trading Co., [1977-1980 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 20,452 (C.F.T.C. 1977); *see also* United States v. Atkins, [1986-1987 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 23,706 (S.D.N.Y. 1987); *In re* O'Brien [1986-1987 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 23,512 (C.F.T.C. 1987); *In re* Grippo, [1987-1990 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 23,114 (C.F.T.C. 1986); *In re* Kuhlik, [1987-1990 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 22,926 (C.F.T.C. 1986); *In re* Flynn, [1984-1986 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 22,488 (C.F.T.C. 1985); *In re* Laspagnoletta, [1984-1986 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 22,507 (C.F.T.C. 1984); *In re* Commodity Exchange Inc., [1984-1986 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 22,443 (C.F.T.C. 1984); *In re* Sundheimer, [1980-1982 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 21,245 (C.F.T.C. 1981), *aff'd sub nom.* Sundheimer v. CFTC, 688 F.2d 150 (2d Cir. 1982), *cert. denied*, 416 U.S. 1022 (1983); *In re* Alfred Perlmutter, CFTC Doc. No. 79033 (Dec. 3, 1979); Markham, *Prohibited Floor Trading Activities Under the Commodity Exchange Act*, 58 Fordham L. Rev. 1, 22-29 (1989) (discussing tax trading abuses and criminal prosecutions that arose from CFTC's efforts to attack those abuses).

The Internal Revenue Service conducted a broad scale effort to collect taxes from individuals engaging in these abusive trading practices. *See* J. Markham, *supra* note 7, at 84, 143, 153-56. One unfortunate individual the IRS targeted in that effort was singer Willie Nelson. His tax straddle transactions resulted in a challenge by the Internal Revenue Service and a subsequent forced sale of most of his assets. Mason, *Mamma, Don't Let Your Babies Grow Up to Work for the Tax Boys*, Wall St. J., Jan. 29, 1991, at C1, col. 3.

Mr. Nelson was not the only one affected by sham futures transactions conducted for tax purposes. The chief executive officer of CBS, Laurence Tisch, and his brother, the former Postmaster General, have filed a lawsuit as the result of the activities of an individual who was convicted of creating over $1.3 billion in phony tax losses. Valeriano & Stevens, *Tisch Brothers Sue Asher Edelman Over Alleged Tax-Fraud Scheme*, Wall St. J., July 23, 1991, at B3, col. 4.

94. *See In re* Buckwalter, 2 Comm. Fut. L. Rep. (CCH) ¶ 24,995 (C.F.T.C. 1991); *In re* Bear Stearns & Co., 2 Comm. Fut. L. Rep. (CCH) ¶ 24,994 (C.F.T.C. 1991); *In re* Gilchrist, 2 Comm. Fut. L. Rep. (CCH) ¶ 24,993 (C.F.T.C. 1991); *In re* Rosenberg, 2 Comm. Fut. L. Rep. (CCH) ¶ 24,992 (C.F.T.C. 1991).

95. *See supra* note 3.

after an examination of the indictments revealed that, even though hundreds of trades were involved, many of the dollar amounts for each trade were small—often less than a few hundred dollars.[96] Consequently, the total amount of money involved was not great, at least as compared to some of the financial scandals that have been observed in recent years in the securities markets.[97] The government also met an initial lack of success in its first trial involving traders in the Swiss franc pit on the Chicago Mercantile Exchange—*i.e.*, convictions were obtained only on a limited number of charges.[98] In addition, in a subsequent trial, the district court severed one trader after the trial began because that trader's defense conflicted with those of his fellow codefendants, raising concern that other traders there would have a basis for appeal in the event of an adverse verdict. Interestingly, the trader was severed because his defense was that the practices at issue were so widespread that they could not be considered to be anything other than normal practice.[99] Those setbacks seemed to have been overcome when the government obtained a number of convictions in its trial involving the soybean pit.[100] More recently, however, the Japanese yen pit trial resulted in a severe setback for the government. The jury announced that it was hung on many of the charges, and it acquitted some of the defendants.

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96. *See Agent Says CME Assisted FBI in Probe of Chicago Exchanges*, Knight-Ridder Money Center News 15,147, Nov. 1, 1990 (government witness testified as to trades in yen pit, none of which resulted in losses of more than $400 to customers); Eichenwald, *Business and the Law; Commodities Charges Widen Use of Racketeering Statute*, N.Y. Times, Aug. 7, 1989, at D1, col. 1 (reporting that knowledgeable authorities viewed the charges as "comparatively minor crimes"). A few of the trades, however, were substantial, particularly at times when market prices changed dramatically. *See* Crawford, *Merc Trader Retraces Trail of Illegal Yen Profits*, Chi. Tribune, Jan. 8, 1991, § 3, at 1, col. 1 (describing two fraudulent transactions that resulted in profits of over $320,000 cumulatively); Burns, *Witness Tells of Pre-Arranged Trades*, Chi. Sun-Times, Oct. 26, 1990 (reporting on trader's testimony as to profit on one trade of $9,000 that was done non-competitively).

97. *See* BROKERS AND BAGMEN, *supra* note 3, at 266. For example, Ivan Boesky agreed to pay a fine of $100 million and was sentenced to jail for three years. Drexel Burnham Lambert also agreed to a settlement with the government pursuant to which it paid a fine of $650 million. R. SMITH, *supra* note 12, at 246-47. However, "[f]ewer than fifty Wall Streeters have been convicted of serious securities law violations during the last decade." *Id.* at 282-83. This should be compared with the 48 persons who were indicted in the Chicago sting operation, over 30 of whom were convicted or pled guilty. *See supra* note 72.

98. McMurray, *supra* note 72, at R20, col. 1.

99. *See* United States v. Bailin, No. 89 CR 668, 1990 U.S. Dist. LEXIS 14,569 (N.D. Ill. Oct. 26, 1990); BROKERS AND BAGMEN, *supra* note 3, at 102, 105 (claiming that exchange floor had its own unwritten code for the benefit of members). Defense counsel claimed that the practices at issue in the Chicago sting involved a "custom and usage" that developed "way before any of [the defendants] were ever out of diapers, much less when they got on the floor." *Bailin*, 1990 U.S. Dist. LEXIS 14,569 at *7. It was further claimed that "everyone, including enforcement agencies, knew of the practices and did not do anything." *Id.* at *9. *See also* Dishneau, *10 Convicted of Fraud in Commodities Case*, Wash. Post., Jan. 10, 1991, at E3, col. 5 (reporting that "[l]awyers for several of the defendants conceded they engaged in curb trades and violated other rules, but they said the actions did not constitute fraud and customers were not hurt").

100. *See* McMurray, *Ten Soybean Futures Traders Convicted in Major Victory for U.S. Fraud Inquiry*, Wall St. J., Jan. 10, 1991, at C13, col. 1.

Nevertheless, over thirty of the forty-eight traders indicted as a result of the Chicago sting operation have been convicted. Retrials are also scheduled for other defendants and more indictments are expected.[101]

The press initially suggested that the problems exposed by the Chicago sting operation could be corrected by prohibiting so-called "dual" trading that now exists on the floors of the exchanges. Dual trading allows floor brokers who are executing customer orders also to trade for their own accounts.[102] Another suggestion was that an improved audit trail would permit detection of these practices and would provide deterrence to traders. In fact, the CFTC has considered both of these issues for over fifteen years. It has made some progress in improving audit trails,[103] and the CFTC and Congress are now proposing restrictions on dual trading.[104] It is doubtful, however, whether those efforts will effectively prevent the type of conduct at issue in the Chicago sting operation because many of the practices at issue in the operation did not involve dual trading. Further, the transactions at issue were often accomplished shortly before or after the close of trading, when timing is most difficult.

Considering the limited amount of money at issue and the mixed results in the trials, one could pass off the Chicago sting operation as simply an over-publicized aberration in the markets. That would be a serious mistake. The testimony from those trials is evidence that the practices at issue are not isolated.[105] The Chicago trials provide strong evidence that the compet-

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101. *See supra* note 73.

102. Markham, *supra* note 93, at 1.

103. *Id.* The CFTC appears to have acknowledged that the audit trail issue has been a prolonged problem in the futures industry, noting that irregularities in trading documents "have not been uncommon." *In re* Gilchrist, 2 Comm. Fut. L. Rep. (CCH) ¶ 24,993 at 37,652, n.22 (C.F.T.C. 1991).

104. *See* 55 Fed. Reg. 1047 (1990); *Proposed Rule Concerning Restrictions on Dual Trading by Floor Brokers*, 2 Comm. Fut. L. Rep. (CCH) ¶ 24,803 (C.F.T.C. Apr. 10, 1990); Block, *Closer Oversight of Commodities Voted by House*, Wall St. J., Mar. 6, 1991, at C6, col. 6. The Federal Trade Commission has criticized the CFTC's efforts to curb dual trading. *See Comment to the Commodity Futures Trading Commission on Proposed Regulation 155.5 from the Staff of the Bureau of Economics of the Federal Trade Commission*, 2 Comm. Fut. L. Rep. (CCH) ¶ 24,885 (C.F.T.C. 1990). Nevertheless, the Chicago Mercantile Exchange is imposing some dual trading restrictions. *See Odd Lots*, Wash. Post, Mar. 20, 1991 at C10, col. 3.

105. The CFTC and the exchanges have also brought additional cases charging abusive trading. *See In re* Russo, No. 91-3 (C.F.T.C. filed Jan. 28, 1991); *In re* Bel, No. 90-29 (C.F.T.C. filed Sept. 25, 1990); *In re* Friedman, No. 90-14 (C.F.T.C. filed June 24, 1990); Salwen, *CFTC Charges Ex-Comex Official In Gold Trades*, Wall St. J., May 16, 1991, at C1, col. 5 (reporting that seven traders were charged with fraudulent trading in gold futures); Salwen, *Futures Agency Settles Charges Against 3 Traders*, Wall St. J., Mar. 13, 1991, at C10, col. 5; *Chicago Merc Suspends and Fines Two $50,000*, Wall St. J., Feb. 6, 1991, at C13, col. 6; *U.S. Accuses 5 Oil Traders*, N.Y. Times, Jan. 29, 1991, at C4, col. 1; CFTC News Release No. 3321-90 (Jan. 20, 1991) (describing settlement of charges involving non-competitive trading by a floor broker); *see also* Marcus & Hagedorn, *Commodity Brokerage Firm Wins Suit Against Commodity Floor Broker*, Wall St. J., May 24, 1991, at B8, col. 1 (describing jury finding that floor broker took opposite side of customer's order causing loss of $159,000).

itive environment upon which the present regulatory system is premised is being undermined by the unhealthy relationship that has developed between floor brokers and locals. Fundamental changes are needed. The futures markets have enjoyed a statutory monopoly that has fostered and sheltered the trading practices at issue. Until that monopoly is broken, or at least weakened, any real reform in the futures markets will be frustrated.

1. *Section 4 of the Commodity Exchange Act*

Section 4 of the Commodity Exchange Act requires that contracts for future delivery be traded on an exchange licensed as a "contract market" by the CFTC.[106] This licensing requirement has been the core of commodity futures legislation since the enactment of the Grain Futures Act of 1922.[107] The licensing requirement prevents the proliferation of unregulated off-exchange futures contracts, and it assures that futures trading will be subject to the regulatory restrictions imposed on traders on licensed commodity exchanges. The concept of exchange-required trading also encompasses a belief that such trading will offer greater benefits to hedging operations and that it will assure more efficient price discovery because all orders will be exposed to a centralized market place.[108] The downside to this requirement is that it creates a monopoly position for licensed exchanges, with all the attending abuses that can be expected from any monopoly. This undesirable situation is compounded by the fact that the exchanges limit the number of their members. That limitation results in special privileges and preferential time and place access to the market. The monopoly benefits enjoyed by these select few is reflected in the cost of exchange memberships, which may cost several hundred thousand dollars.[109]

An analogue to Section 4 may be found in the securities industry. Rule 390 of the New York Stock Exchange (NYSE) prohibits exchange members from acting as dealers or crossing customer orders in stocks that are listed

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106. 7 U.S.C. § 6 (1988).

107. *See supra* note 17.

108. For a discussion of hedging and price discovery, COMMODITY TRADING MANUAL, *supra* note 1, at 11-19.

109. As one article notes:

> The speculators on the futures-exchange floor can make split-second trading decisions based on price changes before an individual has time to pick up a phone and call a broker. Why else would these professional speculators be willing to pay several hundred thousand dollars for what's literally a front row "seat," or membership on an exchange?

McMurray, *A Losing Proposition, Futures Trading Is Usually a No-Win Game For The Small Investor*, Wall St. J., Oct. 19, 1990, at R4, col 1. A Chicago Mercantile Exchange seat sold for about $490,000 in June of 1990, but prices dropped to about $375,000 near year end. Chicago Board of Trade seats have ranged in price from $315,000 to $325,000 during 1990. Taylor, *Futures Become Hot as the Economy Slumps, Sparing Chicago the Fate of Wall Street*, Wall St. J., Dec. 27, 1990, at C1, col. 3; *see also* Dana, *Changing of the Guard*, FUTURES AND OPTIONS WORLD, Jan. 1991 (including chart showing prices of Chicago Mercantile Exchange seat ranging as high as $500,000).

on the NYSE.[110] This rule has been criticized as limiting market-maker competition and as causing stock trading to be shifted to London. Some have suggested that elimination of this rule would encourage the development of proprietary electronic trading systems to compete with the NYSE. Proponents of the rule, however, argue that it prevents market fragmentation that would reduce liquidity, and that it prevents brokerage firms from internalizing customer orders. Such internalizing would result in not exposing customer orders to all market participants.[111]

These arguments are similar in many respects to those offered in favor of and against the continuation of Section 4 of the Commodity Exchange Act. However, investors who wish to engage in off-exchange transactions in listed NYSE stocks may do so through: (1) the "third market" of nonmember over-the-counter dealers; (2) through the "fourth market" of direct investor to investor trades conducted informally or through proprietary electronic systems; (3) by executing transactions on regional exchanges;

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110. Seligman, *The Future of the National Market System*, 10 J. CORP. L. 79, 80, 116 (1984).

111. *See* U.S. CONGRESS, OFFICE OF TECHNOLOGY ASSESSMENT, ELECTRONIC BULLS AND BEARS, U.S. SECURITIES MARKETS AND INFORMATION TECHNOLOGY 11 (1990) [hereinafter ELECTRONIC BULLS AND BEARS]; *see also The Shrinking of the Bid Board, Electronics, New Exchanges and Off-Exchange Dealing are Challenging the Dominance of the New York Stock Exchange and Baffling the SEC*, ECONOMIST, Feb. 16, 1991 at 67 (reporting that one large brokerage firm is now matching trades "in-house when they can, before passing them to the exchange for form's sake"); Epstein, *In Brief/Exchanges: The Big Board's Blues, How Competition Is Draining Liquidity from the New York Stock Exchange*, GLOBAL CUSTODIAN, Dec. 1990, at 32 (describing NYSE's attempt to interpret its Rule 390 to allow trading on foreign exchanges only after close of trading and discussing other means utilized to avoid taking transactions to floor of NYSE because of inefficiencies of NYSE's specialist system); Salwen, *Bill Would Divert Floor Trades Away From Independent Brokers*, Wall St. J., May 15, 1991, at C1, col. 5 (discussing proposed legislation that would cut execution costs for money margins on floor of NYSE at expense of floor brokers on that exchange); Herman and Torres, *Up All Night Watching the War? Got an Urge to Trade?*, Wall St. J., Jan. 22, 1991, at C1, col. 2 (discussing third market transactions off NYSE); Norris, *Phelan Leaves a Remolded Exchange*, N.Y. Times, Dec. 20, 1990, at D1, col. 4 (discussing efforts to broaden trading procedures at the NYSE and improve automation to enhance competition on exchange without damaging specialist interests and explaining that NYSE is seeing unprecedented outflow of business as traders divert more and more trades to regional and electronic exchanges). The NYSE may also face competition from a proposed electronic exchange that will create an auction style marketplace. *See* Day, *The Trials of a Traveling Regulator*, Wash. Post, March 6, 1991, at C9, col. 2 (describing SEC approval of NYSE competitor's proposal that will create "an electronic trading network—the so-called Wunsch system"); Wang, *A Rock Climber's Reach for the Top on Wall Street, Electronic Exchange Takes on Big Board*, N.Y. Times, Jan. 24, 1991, at D1, col. 4. The NYSE is seeking to bring trading back to its floor from London and from competing trading systems. *See Big Board v Small Screen*, ECONOMIST, Apr. 6, 1991, at 12; Hinden, *NYSE Wins Vote For Longer Day*, Wash. Post, May 21, 1991, at D1, col. 5 (reporting that NYSE extending trading hours to compete with competitors world-wide who trade stocks and bonds twenty-four hours a day); Labaton, *Late Stock Trades Approved by S.E.C.*, N.Y. Times, May 21, 1991, at A1, col. 1 (same); Torres, *Big Board Facing Serious Erosion as Market for Stocks, Chief Warns*, Wall St. J., Mar 13, 1991, at C1, col. 5; Power, *Big Board Tries to Lure Program Trades from London*, Wall St. J., Nov. 23, 1990, at C3, col. 3.

(4) by trading in foreign markets such as London; or (5) by conducting "block" trades on the exchange for large size orders, which may be assembled or negotiated off-the-floor. These exceptions to Rule 390 effectively allow large scale off-exchange trading. In fact, some 45 percent of NYSE trades are being done as block trades. The NYSE has also adopted a small order execution system that is designed to pair and process small customer orders automatically—a system that is non-existent on commodity exchanges.[112]

The debate on the competitive restrictions of Rule 390, therefore, is much more academic than that concerning the provisions of Section 4 of the Commodity Exchange Act.[113] For the most part, Section 4 does not contain similar exceptions. No third or fourth market is allowed to exist in futures contracts and, as will be discussed below, block trading has been prohibited. Efforts to create small order execution systems have also been resisted by the exchanges.[114] Only foreign competition is permitted. Although that competition has been virtually non-existent until recent years, foreign futures exchanges are now becoming more competitive and are drawing market share away from the United States.[115] This suggests that a need for competition exists.

2. *Competition from Other Financial Instruments Should be Permitted*

The exchange monopoly requirement of Section 4 of the Commodity Exchange Act raises other issues. The scope of its application is uncertain

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112. *See* ELECTRONIC BULLS AND BEARS, *supra* note 111, at 8, 11; SEC STAFF REPORT, THE OCTOBER 1987 MARKET BREAK 7-16, 7-21 (Feb. 11, 1988) [hereinafter OCT. 1987 MARKET BREAK]. Today, the "third market" is limited in its volume. Labaton, *Extra Time For Trades Expected*, N.Y. Times, May 20, 1991, at D1, col. 6. Moreover, "the NYSE specialists have kept a government protected monopoly in market making. Arguably, the markets for listed securities would have been more efficient than they were during the October 1987 debacle if these markets had been more open to competition." Poser, *Restructuring The Stock Markets: A Critical Look at the SEC's National Market System*, in ABA, SELECTED ARTICLES ON FEDERAL SECURITIES LAW 10 (1991).

113. 7 U.S.C. § 6 (1988).

114. *See infra* note 161 and accompanying text.

115. *See* Platt, *Foreign Competition Snapping at US' Heels*, and *Conflagration or Friendly Rivalry?*, J. COM., May 13, 1991, at 5A (reporting that world market share of Chicago Board of Trade, largest U.S. futures market, slipped from 39% to 27.5% in last five years); *Europe's Futures In Options*, ECONOMIST, Mar. 16, 1991, at 79 (reporting that "American exchanges' share of the global futures market fell from 70% in 1989 to 67% last year, and their share in options from 66% to 59%"); Angrist, *In Search of the "Hot" Futures Contract*, Wall St. J., Apr. 8, 1991, at C1, col. 3 (stating that futures exchanges in United States "search for new contracts, spurred by the hot breath of foreign competition"). Global trading of derivative instruments is also expected to increase dramatically in the coming decade. *See* Sesit, *Global Sales of Securities Seen Growing*, Wall St. J., Nov. 23, 1990, at C1, col. 4. The United States exchanges, however, argue that this loss of market share is due to government regulations. McMurray, *New Plan to Tax Futures Traders Isn't a Sure Loser*, Wall St. J., Feb. 7, 1991, at C1, col. 3; *accord* Simon, *Foreign Investment Exodus Seen if U.S. Toughens Rules*, J. COM., Mar. 7, 1990, special report, at 7A, col. 3.

and the breadth of its reach has resulted in the stifling of other commercial markets. With regard to the former, the Commodity Exchange Act grants the CFTC "exclusive" jurisdiction over futures contracts,[116] and Section 4 requires such contracts to be traded only on contract markets.[117] But the Commodity Exchange Act nowhere defines what constitutes a futures contract. Instead, the statute simply states that it terms do not apply to so-called "deferred delivery" contracts.[118] These are merely forward contracts used by commercial traders, rather than small speculators. This lack of definition led to much confusion in the development in the 1980s of so-called "hybrid" instruments such as swap contracts, interest rate floors and ceilings and debt instruments that tied their returns to commodity indexes.[119]

Reluctant to cede its exclusive jurisdiction, the CFTC has also taken an expansive view of the scope of Section 4. This has caused much confusion as to whether particular commercial transactions are permitted. Efforts by the CFTC to alleviate that confusion have not been successful in that its interpretations and "safe harbors" have, to date, been quite narrow.[120] A dramatic example of the deleterious effect of the contract market monopoly in this context involves the Brent Oil market. Brent crude oil is a blend of the production of a number of fields in the North Sea, with the system terminal located in Sullom Voe, Scotland. The Brent market is truly an

116. 7 U.S.C. § 2(a) (1988).

117. 7 U.S.C. § 6 (1988).

118. 7 U.S.C. § 2(a) (1988). *See generally* 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 Instruments*, 41 BUS. LAW. 853 (1986).

119. *See generally* Hu, *Swaps, The Modern Process of Financial Innovation and the Vulnerability of a Regulatory Paradigm*, 138 U. PA. L. REV. 333 (1989); Gilberg, *Regulation of New Financial Instruments Under the Federal Securities and Commodities Laws*, 39 VAND. L. REV. 1599 (1986); Schroeder, *Inadvertent Futures Contracts*, 19 REV. OF SEC OF COM. REG. 89 (1986); Stein, *The Exchange-Trading Requirement of the Commodity Exchange Act*, 41 VAND. L. REV. 473 (1988).

120. *See generally* Markham, *Regulation of Hybrid Instruments Under the Commodity Exchange Act: A Call for Alternatives*, 1990 COLUM. BUS. L. REV. 1 (1990). The CFTC has tried to apply mathematical formulas to determine whether a transaction has only de minimis futures or options elements that would exclude it from the Commodity Exchange Act. *See id.* The CFTC has also sought to include this methodology in pending legislation. However, one Senator said that this approach "is like trying to put a mathematical definition on obscenity." Block, *Senate Panel Votes to Bolster CFTC Powers*, Wall St. J., March 7, 1991, at C12, col. 5. The chairman of the Federal Reserve Board has further stated that this approach could impair new financial products, including swaps. *Greenspan Says Bill on Futures May Hurt Financial Innovation*, Wall St. J., Mar. 22, 1991, at C12, col. 6; *see also* Hinden, *Futures Rules, Headed For Vote in Senate*, Wash. Post, Apr. 17, 1991, at B1, col. 2; Labaton, *Compromise On Financial Regulation In Jeopardy*, N.Y. Times, Apr. 17, 1991, at D20, col. 3. Nevertheless, the CFTC approach was adopted by the Senate. *See* Salwen, *Senate Feels the Impact of Marriage as Gramms Push Through Markets Bill*, Wall St. J., Apr. 26, 1991, at B4C, col. 1 (reporting that Senator Phil Gramm, his wife, who is CFTC Chair, and "politically powerful Chicago futures exchanges" achieved Senate passage of this controversial provision); Hinden, *Senate Vote Gives CFTC Regulatory Victory*, Wash. Post, Apr. 19, 1991, at C1, col. 5; Salwen, *Senate Passes Bill on Introducing Financial Products*, Wall St. J., Apr. 19, 1991, at C1, col. 5.

international market. In *Transnor (Bermuda) Ltd. v. B.P. North American Petroleum*,[121] however, a U.S. district court held that transactions in the Brent Oil Market are futures contracts that are subject to the Commodity Exchange Act. The parties to the contracts at issue were a Bermuda corporation plaintiff and defendant non-U.S. oil companies who had sold oil to the plaintiff that was destined for delivery in Scotland. All of the transactions were effected through London and were made expressly subject to English law. Nevertheless, the court concluded that the contracts were futures contracts under the Commodity Exchange Act because many other participants in the market were U.S. based and two of the leading trading centers in Brent Oil were in the United States.

This decision raised concern that the Brent Oil Market would be damaged and that U.S. traders would be excluded from that market. In fact, many traders did move their operations offshore and refused to deal with U.S. counterparties. The CFTC subsequently issued a statutory interpretation which sought to assert that the district court decision in *Transnor* was wrong and that the Brent Oil Market should be treated as a commercial forward market that was not regulated under the Commodity Exchange Act.[122] It is unclear how successful that effort will be, particularly since the CFTC has rejected another judicial decision which held that transactions between commercial traders were not subject to the Commodity Exchange Act.[123] The *Transnor* decision also exposes the danger of granting the CFTC exclusive jurisdiction—that there is no middle ground. The CFTC has no power to grant an exemption. If the contract is subject to the Commodity Exchange Act, it must be traded on a licensed contract market.[124]

The uncertainty created by Section 4 does not rest with the Brent Oil Market. So-called "swap" transactions have proliferated to the extent that they are themselves a major commercial enterprise. Uncertainty as to the scope of Section 4, however, has given rise to concern that a court applying a broad approach to Section 4 may declare these transactions to be illegal. Swap dealers have attempted to obtain legislation that would exempt these

121. 738 F. Supp. 1472 (S.D.N.Y. 1990).

122. *See Statutory Interpretation Concerning Forward Transactions*, 2 Comm. Fut. L. Rep. (CCH) ¶ 24,925 (C.F.T.C. Sept. 25, 1990); *see also* Bettelheim & Markham, *The Transnor Decision and Its Aftermath*, 8 Oil & Gas L. & Tax Rev. 76 (1990). For a discussion of the Brent Oil Market see Sass, *The Legal Aspects of the 15-Day Brent Market*, 5 J. Energy & Nat. Resources L. 182 (1987).

123. *See* Krommenhoek v. A-Mark Precious Metals Inc., 2 Comm. Fut. L. Rep. (CCH) ¶ 24,952 (D. Idaho 1990). The CFTC asserted in *Krommenhoek*, as *amicus curiae* to the Ninth Circuit Court of Appeals, that even commercial transactions are subject to the Commodity Exchange Act. Brief of the CFTC, Amicus Curiae, Krommenhoek v. A-Mark Precious Metals, 2 Comm. Fut. L. Rep. (CCH) ¶ 24,952 (D. Idaho 1990). Some hybrid offerings are going forward. *See* Angrist, *New Securities Tie Investors to Silver Prices*, Wall St. J., May 20, 1991, at C1, col. 3.

124. *See generally* Bettelheim & Markham, *More On Transnor*, 8 Oil & Gas L. & Tax Rev. 223 (1991); Foley, *Forwards vs. Futures, The Great Debate*, FIA Review, Mar./Apr. 1991, at 12.

transactions, but, to date, they have been unsuccessful.[125] The CFTC has sought to allow these and some other hybrids to trade, but the approach it has taken has been piecemeal and restrictive. For example, in order to preserve its exclusive jurisdiction under Section 4 and to ward off SEC incursions into its jurisdiction, the CFTC has discouraged development of off-exchange bonds that were indexed to oil prices.[126] The crisis with Iraq, however, suggests that these could have been valuable investments.

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125. *See Over the Counier or On The Exchange?*, EUROMONEY, Dec. 1990; *Commodities: How to Avoid the Pain*, EUROMONEY, Dec. 1990 (describing commodity swaps); Young & Stein, *Swap Transactions Under The Commodity Exchange Act: Is Congressional Action Needed?* 76 GEO. L.J. 1917 (1988); Note, *Oil-Price Swaps: Should These Innovative Financial Instruments Be Subject to Regulation by the Commodity Futures Trading Commission or the Securities and Exchange Commission?*, 93 DICK. L. REV. 367 (1989). Legislation has been proposed in Congress that would direct the CFTC to exempt swap agreements and certain hybrid bank products from the provisions of the Commodity Exchange Act where such transactions are subject to individual negotiations and are undertaken in connection with a line of business. *See Swaps Regulation Needed Despite CFTC's Collar Interpretation*, SEC. WK., Feb. 5, 1990, at 9. For a discussion of swap transactions, see Cosgrove, *Commodity Swaps Next Big Financial Investment?*, J. Com., June 25, 1990 at Special Report, 9A, col. 1; Hu, *Swaps, The Modern Process of Financial Innovation and the Vulnerability of a Regulatory Paradigm*, 138 U. PA. L. REV. 333 (1989).

Uncertainty in swaps dealing has also arisen in Great Britain as the result of a ruling by the House of Lords that restricts local government agencies' abilities to engage in such transactions. *See* Corrigan, *Lords Rule Rate Swaps Illegal, More Than 100 Local Authorities Could Now Face Legal Action From Their Banks*, Fin. Times, Jan. 25, 1991, § 1, at 18, col. 1; *see also British Local-Authority Swaps, We're a Special Case, Old Chap*, ECONOMIST, May 11, 1991, at 74 (reporting that British government refuses to seek legislation to change decision of House of Lords).

126. *See* Russ & Vinciguerra, *Financial Innovation and Uncertain Regulation: Selected Issues Regarding New Product Development*, 69 TEX. L. REV. 1431 (1991) (stating that "[u]ntil this statutorily required and increasingly meaningless dichotomy between futures and securities is rejected as the touchstone for determining regulatory jurisdiction over new products, the jurisdictional conflict and innovation-inhibiting trends that this conflict has engendered undoubtedly will persist"); *see also* Gilberg, *supra* note 119, at 1665-66; *Commodities: How to Avoid the Pain*, EUROMONEY, Dec. 1990, special supplement, at 54 (explaining that CFTC's jurisdiction created uncertainty and precluded development of markets for synthetic commodities and commodity-linked bonds, although recent regulatory efforts by the CFTC have allowed expansion).

Over-the-counter markets in derivative instruments are expected to grow rapidly abroad in future years and to pose competition to futures trading abroad. The United States should be allowed to have that same competition developed here. *See Europe's Futures in Options*, ECONOMIST, Mar. 16, 1991, at 79. Interestingly, the CFTC has permitted foreign governments to trade hybrid instruments in the United States in the form of detachable warrants that are tied to commodity prices even though it has not permitted such transactions for individuals in the United States. *Compare Order Authorizing Uruguay to Issue and Sell and Holders Thereof to Resell, Units Consisting of Certain Detachable Rights*, 2 Comm. Fut. L. Rep. (CCH) ¶ 25,008 (C.F.T.C. 1991) *and Order Authorizing Mexico to Issue and Sell, and Holders Thereof to Resell, Units Consisting of Certain Detachable Fights*, 2 Comm. Fut. L. Rep. (CCH) ¶ 24,801 (C.F.T.C. 1990) *with Interpretive Letter No. 85-4*, [1984-1986 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 22,802 (C.F.T.C. Sept. 17, 1985) *and CFTC's Letter No. 85-7*, [1984-1986 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 22,727 (C.F.T.C. Mar. 6, 1985).

3. *Section 4 and the CFTC 's Exclusive Jurisdiction Should be Modified*

The need for the continued existence of Section 4 and the grant of exclusive jurisdiction to the CFTC should be re-examined. When this provision was initially made the central part of the federal regulatory scheme in 1922, and when it was carried forward in 1936, there was no effective alternative regulation of off-exchange instruments. Efforts to regulate off-exchange futures as gambling contracts had failed. The federal securities laws were also in their infancy at the time of the adoption of the Commodity Exchange Act. Consequently, Section 4 made good sense. Today, however, the federal securities laws have matured on both the state and federal level. Consequently, if off-exchange transactions are treated as securities, there is assurance of effective alternative regulation.[127]

Therefore, if a commercial transaction is subject to federal securities laws, or if it is subject to an exemption under the federal securities laws, such transactions should be freely permitted. For example, SEC Regulation D permits limited offerings of unregistered securities to so-called "accredited" investors who are large traders able to fend for themselves and who do not need regulatory protection.[128] Similarly, if an offering of a hybrid

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127. This is not to suggest that additional regulation may not be needed for off-exchange instruments once they are freed from the exchange monopoly. Indeed, the limited market in off-exchange instruments allowed by the CFTC may already need regulatory scrutiny. *See American Investment Banking: Beyond The Balance Sheet*, ECONOMIST, May 11, 1991, at 74 (stating that off-balance sheet investments in derivatives by banks "expose banks to a potentially huge credit risk if there are defaults"); Lohr, *How B.C.C.I. Accounts Won Stamp of Approval*, N.Y. Times, Sept. 16, 1991, at A1, col. 1 (reporting that Bank of Credit and Commerce International concealed huge losses in financial futures and options); McCoy, *Bad Bets: Many Big S&L Losses Turn Out to be Due to a Financial Gamble*, Wall St. J., Aug. 9, 1991, at A1, col. 6 (discussing large losses by savings and loan institutions from exotic trading activities); Torres, *Bull Market for Derivatives Outruns Rules*, Wall St. J., July 24, 1991, at C1, col. 3 (stating that $3 trillion derivative market has outgrown its regulators); Block, *SEC Chief Suggests Ending Coverage of Bank Derivative Securities by FDIC*, Wall St. J., June 21, 1991, at C2, col. 3 (reporting that failing bank's $30 billion in currency and interest rate hybrid contracts proved costly to unwind, and that situation suggested that such off-balance sheet instruments pose threat to global banking economy); Torres, *Dangerous Deals: How Financial Squeeze Was Narrowly Avoided in 'Derivatives' Trade*, Wall St. J., June 18, 1991, at A1, col. 6 (same); *see also* Hu, *New Financial Products, the Modern Process of Financial Innovation, and the Puzzle of Shareholder Welfare*, 69 TEX. L. REV. 1273 (1991) (stating that introduction of new hybrid financial instruments poses serious challenges to existing corporate law framework). Credit risk problems in off-exchange instruments have also provided a competitive opportunity for the commodity exchanges. *See* Taylor, *Board of Trade Reaches for Swaps Market*, Wall St. J., June 20, 1991, at C1, col. 3.

For a discussion of the scope and operation of the federal securities laws, see generally T. HAZEN, THE LAW OF SECURITIES REGULATION (1989); I-IX L. LOSS & J. SELIGMAN, SECURITIES REGULATION (3d ed. 1989-1991). The Clark Boardman publishing company has also established a virtual library of treatises on federal securities regulation. *See, e.g.*, H. BLOOMENTHAL, INTERNATIONAL CAPITAL MARKETS AND SECURITIES REGULATION (1990); R. HAFT & P. FASS, INVESTMENT LIMITED PARTNERSHIPS (1990); D. LIPTON, BROKER-DEALER REGULATION (1990); J. LONG, BLUE SKY LAWS (1990).

128. *See* 17 C.F.R. § 230.501-.506 (1986); *see also* 7A J. HICKS, EXEMPTED TRANSACTIONS

security is to be made to the public, and if it is registered under the federal securities laws, it should be permitted, notwithstanding the restrictions of Section 4. The federal securities laws provide full and adequate protection to investors in the form of disclosures and in rights and remedies where fraud is committed.[129] This approach would assure that commercial transactions and public investments are allowed without undue restriction and would allow less fettered development of new contracts. The competition that would be provided to the futures exchanges could also do much to eliminate the abuses that occur under the existing exchange monopoly. Market users who are dissatisfied with paying for the monopoly practices of exchange franchisees—exchange members—, or of the abuses uncovered by the Chicago sting, could seek a market alternative.

The argument against this approach is, of course, that the elimination or restriction of Section 4 can undercut the commodity exchanges because they will no longer be the statutory central marketplace. Price discovery—an important feature of commodity futures trading—, market liquidity and other beneficial aspects of futures trading may be reduced. However, if commercial markets or speculative investments occur outside of the exchanges, this would simply underscore the fact that there is a competitive need for such services. If the exchanges no longer serve their price discovery function, then that is a competitive decision that is being made by market participants because they find other investments to be more desirable or competitive. Moreover, competition should make the exchanges more efficient and effective, rather than less so. Indeed, competition could assure that the exchanges remain innovative by creating new, more attractive futures contracts and that their marketplaces remain free of fraud and achieve maximum efficiency in the execution of customer orders.[130] It would also seem out of place for the exchanges, who bill themselves as the last bastions of free competition, to claim that they should continue to be given a regulatory monopoly over commodity-based transactions.[131]

UNDER THE SECURITIES ACT OF 1933, ch. 7 (1987); III L. LOSS & J. SELIGMAN, *supra* note 127, at 1389-1450; Campbell, *The Plight of Small Issuers (And Others) Under Regulation D: Those Nagging Problems That Need Attention*, 74 KY. L.J. 127 (1985).

129. For a discussion of the registration and prospectus requirements of the federal securities laws, see 1-1b H. BLOOMENTHAL, GOING PUBLIC AND THE PUBLIC CORPORATION (1990).

130. A similar conclusion was reached by an industry advisory committee to the CFTC in 1976. The committee considered whether the proliferation of futures contracts should be a matter of regulation by the CFTC. The advisory committee stated that "[p]roliferation of contracts should not concern the Commission. Market users should be left free to decide which contract to use when more than one is available. The stimulus of inter-exchange competition can lead to better contracts." *Report of the CFTC Advisory Committee on the Economic Role of Contract Markets*, [1975-1977 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 20,187 at 21,065 (July 19, 1976) (footnote omitted).

131. *See* Laing, *U.S. Study of Soybean Trading is Seen Leading to Tax-Law, Other Indictments*, Wall St. J., Aug. 9, 1976, at 18, col. 2. The motto of one exchange and the trading jackets of one Chicago Mercantile Exchange member firm also claimed that the futures

In order to implement this needed reform, the Commodity Exchange Act should be amended by including a provision in the statute which would state that Section 4 does not apply to transactions that are subject to regulation under the federal securities laws. A less desirable alternative would be to give the CFTC exemptive powers for a particular transaction. This would be less desirable simply because the CFTC would be inclined to continue the preservation of its jurisdiction by imposing unduly restrictive requirements on exempted transactions or by simply denying the exemption.[132]

4. *Self-Regulation*

Coupled with the exchange trading requirement of Section 4 is the concept of self-regulation pursuant to which the rules and directives of the exchanges, in large measure, establish the regulation of commodity futures trading. This is because the CFTC, and its predecessor the CEA, have traditionally deferred to the exchanges' rulemaking and other self-regulatory activities. Although exercising an oversight role, the government has only rarely sought to exercise its powers affirmatively. This deference has continued despite the fact that there were numerous self-regulatory failures

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markets were "free markets for free men." McMurray, *Sandner Regains Merc Chairmanship, Defecting Rival Linked to Melamed*, Wall St. J., Jan. 17, 1991, at C8, col. 5; *accord* McMurray, *A Losing Proposition, Futures Trading is Usually a No Win Game for the Small Investor*, Wall St. J., Oct. 19, 1990, at R4, col. 1.

The exchanges, however, are unabashed in their view that loosening the requirements of section 4 constitute "an assault on their business franchises." Gold, *A Tale of Two Cities, The New York and Chicago Exchanges Battle for Control of Stock Futures Trading*, FIN. WORLD, Oct. 16, 1990, at 42. Clearly, the commodity futures exchanges have also used the provisions of Section 4 and the competitive monopoly that it gives them to delay and prevent the expansion of competing instruments. *See, e.g.*, Board of Trade v. SEC, 923 F.2d 1270 (7th Cir. 1991); Chicago Mercantile Exchange v. SEC, 883 F.2d 537 (7th Cir. 1989); Chicago Board of Trade v. SEC, 677 F.2d 1137 (7th Cir.), *vacated as moot*, 459 U.S. 1026 (1982). For a discussion of commodity exchange efforts to stop competition by utilizing regulatory barriers, see Eichenwald, *Marketplace: What Constitutes an "Exchange"?*, N.Y. Times, Feb. 8, 1991, at D6, col. 3. In fact, competition among the exchanges seems to be lessening as they consider joint operations and mergers. *See* BROKERS AND BAGMEN, *supra* note 3, at 77, 122; *Chicago Exchanges Unlikely to Merge*, J. COM., Nov. 28, 1990 (discussing efforts by the Chicago exchanges to enter into joint ventures); Simon, *Exchange Rivalries Fading*, J. Com., Oct. 10, 1990, Special Report at 11A, col. 3; *Will Chicago's "Wall" Come Down?*, FUTURES & OPTIONS WORLD, Oct. 1990 (discussing possible joint operations of Chicago Board of Trade and Chicago Mercantile Exchange).

132. Another alternative is to consolidate the jurisdiction of the CFTC and the SEC. *See* Russo & Vinciguerra, *supra* note 126. The securities industries continue to seek to develop new products that will compete with futures contracts. *Amex Proposes to Resurrect Equity Index Participations*, INVESTMENT DEALERS DIG., Dec. 10, 1990. Provisions that would lessen the exclusive jurisdiction of the CFTC were proposed in Congress, but were defeated. *See supra* note 120. Nevertheless, the SEC continues to take an approach opposite that of the CFTC. The SEC has been approving nonexchange products that can compete with the regulated securities exchanges. *See* Board of Trade v. SEC, 923 F.2d 1270 (7th Cir. 1991); Securities Exchange Act Release No. 25,708, 54 Fed. Reg. 15,429 (1989).

during the tenure of the CEA. Those failures were well documented in 1974 when the CFTC was created, but the CFTC continued to defer to the exchanges, and it continues to do so despite continued self-regulatory lapses.[133]

Because of this deference and the exchanges' statutory monopoly position, the exchanges have amassed a most powerful position. The exchanges seem to have a stranglehold over legislation that affects them through their political influence on the agricultural committees, which control the CFTC, and through other members of Congress. Large amounts of funds are spent by exchanges in lobbying efforts and propaganda to frustrate legislative reform.[134] Campaign contributions have, on at least one occasion, intruded

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133. For example, the CFTC took no action during two of the largest crises facing the futures markets—the silver crisis of 1980 and the Stock Market Crash of 1987. *See* Markham, *supra* note 9, at 343-50; *see also* H.R. REP. No. 975, 93d Cong., 2d Sess. 38-39, 48 (1974); S. Rep. No. 1131, 93d Cong. 2d Sess.; *Hearings Before the House Subcommittee on Special Small Business Problems With the Permanent Select Committee on Small Business on Problems Involved in the Marketing of Grain and Other Commodities*, 93d Cong., 1st Sess. 113 (1973) (memorializing statement that exchange regulation is like "putting the fox in charge of the henhouse"); Markham & Schobel, *Self-Regulation Under the Commodity Exchange Act—Can the CFTC Make It Work?*, Sec. Reg. & L. Rep. (BNA) Special Supp. No. 368 (Sept. 1, 1976).

The CFTC has been viewed as "nearly always [being] defensive of the industry it regulates." ELECTRONIC BULLS AND BEARS, *supra* note 111, at 83; *see also* BROKERS AND BAGMEN, *supra* note 3, at 157 (describing CFTC as a "'puppydog' regulator" that is "underfunded and inept"). For example, the CFTC approved a proposal by the exchanges that allows brokers to retain profits from out-trades with customers. Letter from Jean Q. Webb, Secretary of the CFTC, to Mary Irwin, Director, Legal and Regulatory Division of the Chicago Mercantile Exchange (August 24, 1991). An out-trade occurs where the trade did not clear properly overnight because of an input error or omission. Such out-trades were used in some of the fraudulent schemes uncovered by the Chicago sting operation. Previously, all profits from errors went to customers, with brokers absorbing any losses. By approving this proposal, the CFTC may have provided a further incentive to engage in "error" transactions. *See CFTC to Sanction Out Trade Profits For Brokers*, Wall St. Letter, Jan. 21, 1991.

134. It was recently reported that the two Chicago futures exchanges were the leading sponsors of privately funded trips for House members in 1989 and 1990. *See What's News*, Wall St. J., Sept. 13, 1991, at A1, col. 3; *see also CBT Clearing Corp. Will "Acquiesce" to Misdemeanor Charges*, SEC. WK., Sept. 24, 1984, at 8; Hinden, *Lobbying Efforts Stop New Rules on Futures*, Wash. Post, Oct. 25, 1990, at E1 (reporting that "powerful futures and agricultural lobby" successfully stopped efforts to impose restrictions on futures markets); Atlas, *Bush Urges SEC Rule of Futures*, Chi. Tribune, May 9, 1990, § 3, at 1, col. 6 (discussing lobbying efforts by exchanges in opposition to Administration proposals that followed in wake of Stock Market Crash of 1987); Gaines, *Right to Regulate at Stake, CBOT Says*, Chi. Tribune, Feb. 24, 1989, § 3, at 3, col. 5 (reporting exchange announcement, after being criticized by CFTC, that its executives will lobby to assure that "member committees who understand the delicacy of the matters will regulate and not bureaucrats with little or no understanding of futures markets"); Knight, *Commodity Sting Focuses on Flaws In Futures Trading*, Wash. Post, Jan. 29, 1989, at A1, col. 1 (reporting that one exchange contributed almost $1 million to congressional campaigns between 1983 and 1989 and paid Congressmen honoraria); Atlas, *Urgency for Congress to Act Fades As Market Stabilizes*, Chi. Tribune, Oct. 16, 1988, § 7, at 2, col. 2 (reporting that one exchange had a political campaign chest of $1.5 million and that contributions of $500,000 were made to exchange's political action committee in a period of ten weeks after the Stock Market Crash of 1987); Povich & Jouzaitis,

into the criminal area.[135] Numerous suits and public opposition to CFTC rules by the exchanges have been used to prevent or obstruct CFTC regulation.[136] Although the exchanges did lose in their effort to prevent the creation of the CFTC in 1974, they have since effectively captured that agency. Only rarely has the CFTC ever acted in a market emergency and today it has virtually conceded that it will not do so. Rather, it will simply defer to the exchanges to undertake whatever action the exchanges think appropriate no matter how far reaching or threatening a market emergency (as was the case with the Stock Market Crash of 1987).

Cures From Capital Hill, Chi. Tribune, Nov. 8, 1987, § 7, at 1, col. 3 (explaining that exchanges have headed off legislation in past and that they contribute large amounts of money for congressional campaigns); Cohen, *Shootout on the 'Audit Trail'*, Chi. Tribune, Mar. 2, 1986, § 7, at 3, col. 2 (exchanges seek to block CFTC efforts to improve audit trail and that two Chicago exchanges have political actions committees with total of almost $1 million in funds); Cohen, *New Trading Rule Draws Heat: Futures Exchanges Ask Congress to Intervene*, Chi. Tribune, Feb. 20, 1986, § 3, at 3, col. 1 (stating that exchanges are known for "effective lobbying"); *Agency Set to Push for Down-to-the-minute Futures Records*, Chi. Tribune, Jan. 19, 1986, Business Section, at 6, zone S (reporting that one exchange established $1 million "legal defense fund" to fight CFTC efforts to tighten audit-trails on exchanges); Cohen, *Once-Meek Futures Agency Now Busy Stepping on Toes*, Chi. Tribune, Jan. 5, 1986, § 7, at 1, col. 4 (reporting that exchange handed out buttons to be worn by its members stating "endangered species? Ask the CFTC," and that exchange started campaign to increase political contributions); Hines, *Costly Silver Spoons: CBOT, Merc Pay Senators $46,000*, Chi. Sun-Times, May 25, 1984 (two Chicago exchanges are among top ten contributors of "honoraria" to Senators). For a more complete discussion of the political activities of the Chicago exchanges, see BROKERS AND BAGMEN, *supra* note 3, at 5, 122, 149-54.

The exchanges' lobbying efforts continue to be successful in curbing legislation that would affect the futures markets. The head of one exchange boasted that he traveled to Washington to lobby Congress over 100 times following the Stock Market Crash of 1987 in a successful effort to curb legislation. Merrion, *Donovan's Future, CBT's Skillful Boss Emerges as a Leader*, Crane's Chi. Bus., No. 17, Mar. 11, 1991, at 1, col. 3.

135. *See CBT Clearing Corp. Will "Acquiesce" to Misdemeanor Charges*, SEC. WK., Sept. 24, 1984, at 8; Cohen, *Test is Clear For Clearing Corp. Chief*, Chi. Tribune, May 13, 1985, § 7, at 13, col. 1; Leighty, *Futures-Campaign*, Associated Press A.M. Cycle, Nexis, Sept. 13, 1984.

136. *See, e.g.*, Board of Trade v. CFTC, 704 F.2d 929 (7th Cir. 1983); CFTC v. Board of Trade, 701 F.2d 653 (7th Cir. 1983); Board of Trade v. CFTC, 627 F.2d 392 (D.C. Cir. 1980); Board of Trade v. CFTC, 605 F.2d 1016 (7th Cir. 1979), *cert. denied*, 446 U.S. 928 (1980); Board of Trade v. CFTC [1982-1984 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 22,083 (N.D. Ill. 1984); Commodity Exch. Inc. v. CFTC, [1980-1982 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 21,445 (S.D.N.Y. 1982); Board of Trade Clearing Corp. v. United States, [1977-1980 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 20,534 (D.D.C. 1978); Board of Trade Clearing Corp. v. United States, [1975-1977 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 20,246 (D.D.C. 1976); *see also* Markham, *supra* note 9.

Most recently, the commodity exchanges in New York exposed an FBI sting operation and prevented the FBI agents from carrying out their operations. *See* Power, *Commodity Exchanges Unmask FBI 'Traders'*, Wall St. J., Mar. 27, 1991, at C1, col. 3; *see also* Simon, *Aborted FBI 'Sting' Operation in NY Rattles Exchanges*, J. Com., March 28, 1991. This led to an investigation to determine whether exchange officials were guilty of obstruction of justice. Cohen, Angrist & Salwen, *U.S. Probes Comex Aides Over Uncovering of FBI Sting*, Wall St. J., Apr. 19, 1991, at C1, col. 3.

The concept of self-regulation has an analogue in the securities industry. The Securities Exchange Act of 1934 establishes a "federally mandated duty of self-policing by exchanges," accompanied by the regulatory oversight of the Securities and Exchange Commission.[137] The oversight role employed by the SEC, however, has been much stronger than that taken by the CFTC under the Commodity Exchange Act. In the words of the late Supreme Court Justice, William O. Douglas, a former chairman of the SEC, self-regulation in the securities industry envisions that, while the exchanges will take a leadership role, the "[g]overnment will keep the shotgun, so to speak, behind the door, loaded, well oiled, cleaned, ready for use but with the hope it would never have to be used."[138] An attitude also prevails in the securities industry that regulation is both appropriate and necessary. As Donald Regan, the head of Merrill Lynch and later Secretary of the Treasury, testified some years ago, "there is a need for regulation in our industry, human beings being what they are. . . . [i]t has brought prosperity to our industry, the fact that we are regulated, that the investor feels that in going to Wall Street, they are not necessarily going into a den of iniquity or a place of thieves."[139]

Yet, even in the securities industry there are concerns of conflicts of interest and that the exchanges will use their self-regulatory role to limit competition. The Supreme Court has noted that the concept of self-regulation embodied in the federal securities laws "contemplates that the exchange will engage in constraints of trades which might well be unreasonable absent sanctions of the Securities Exchange Act."[140] Nevertheless, the securities exchanges and the securities industry have played a much more forceful role than the commodity exchanges in regulating their respective industries. More importantly, the securities self-regulators have not engaged in the same obstructionist role that the exchanges have played in the commodity futures industry. To the contrary, the securities industry has stepped up its enforcement and surveillance systems and has served as an effective appendage to the SEC enforcement efforts.[141]

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137. Silver v. New York Stock Exchange, 373 U.S. 341, 352 (1963).

138. W. DOUGLAS, DEMOCRACY IN FINANCE 82 (Allen ed. 1940).

139. *Securities Industry Study, Hearing Before the Senate Subcommittee on Securities for the Committee on Banking, Housing and Urban Affairs*, 93d Cong., 2d Sess., pt. 2, at 26 (1972).

140. *Silver*, 373 U.S. at 352. Moreover, as Adam Smith noted over two hundred years ago:

> People of the same trade seldom meet together, even for merriment and diversion, but the conversation ends in a conspiracy against the public. . . . [T]hough the law cannot hinder people of the same trade from sometimes assembling together, it ought to do nothing to facilitate such assemblies, much less to render them necessary.

A. SMITH, THE WEALTH OF NATIONS 128 (W. Cannan ed. 1937).

141. There have, however, been self-regulatory breakdowns on the securities exchanges. In 1963, for example, the SEC found there had been a complete breakdown of self-regulatory standards and controls on the American Stock Exch. *Report of Special Study of Securities Markets of the SEC*, H.R. Doc. No. 95, 88th Cong., 1st Sess., pt. 4, at 751 (1963) [hereinafter

Unfortunately, the commodity exchanges have not always proceeded in the same enlightened manner. For example, the existence of perceived conflicts of interest has resulted in charges and counter charges whenever a market emergency erupts. To illustrate, it was charged in 1979 that a small number of traders on the Chicago Board of Trade had amassed a control position in the March 1979 wheat futures contract. The CFTC declared an emergency in that contract but the CFTC's action was blocked temporarily, but effectively, by the Chicago Board of Trade in a proceeding filed over a weekend.[142] At the time of the CFTC's concern with these events, one of the traders involved was a member of the Board of Governors of the exchange and while he did not participate in the voting, he did attend the meetings where the Board of Directors of the exchange considered which actions it should take.[143]

Special Study]; *see also*, Gaines & Crawford, *SEC Says CBOE Ignored Suspect Trades, Three Exchange Execs Took Part in Bid to Increase New-Product Volume*, Chi. Tribune, May 1, 1989, § 7, at 1, col. 4 (reporting that prearranged trading designed to inflate volume figures engaged in on Chicago Board Options Exchange). Nevertheless, the SEC has recognized that regulation "in the field of securities should continue to be based on the principle of giving maximum scope to self-regulation, wherever to the extent that a regulatory need could be satisfactorily met through self-regulation." *Special Study*, *supra*, at 726. Congress also has stated that "the self-regulatory roles of the exchanges and the NASD have been major elements of the regulatory scheme of the Exchange Act since 1934 and 1938. . . . [T]he committee believes it should be preserved and strengthened." S. REP. No. 75, 94th Cong., 1st Sess. 201 (1975). For a discussion of securities exchanges and NASD self-regulation, see generally Miller, *Self-Regulatory Organizations in the Securities Industry: Does Membership Have Its Privileges?*, 19 SEC. REG. L.J. 3 (1991); Miller, *Self-Regulation of the Securities Markets: A Critical Examination*, 42 WASH. & LEE L. REV. 853 (1985).

142. *See* Board of Trade v. CFTC, 605 F.2d 1016 (7th Cir. 1979), *cert. denied*, 446 U.S. 928 (1980); Markham, *CFTC Emergency Powers*, 12 REV. SEC. REG. 863 (1979).

143. *See CFTC Reauthorization, Hearings on H.R. 5447 Before the Subcommittee on Conservation, Credit and Rural Development of the House Committee on Agriculture*, 97th Cong., 2d Sess. 717-722 (1982); *March Wheat Futures Trading on the Chicago Board of Trade, Hearing Before the Subcommmittee on Conservation and Credit of the House Committee on Agriculture*, 96th Cong., 2d Sess. (1979). The Washington Post and other newspapers charged that the Vice Chairman of the Chicago Board of Trade had sat in on policy-making discussions by the exchange's board of directors when they considered what action should be taken with respect to the wheat contract. The Vice Chairman did not participate in the discussions, but he and one of his partners were two of the four persons controlling some ninety percent of the March wheat contract. Knight, *Wheat Probe Calls Witnesses*, Wash. Post, Mar. 23, 1979, at F1, col. 3; *see also* BROKERS AND BAGMEN, *supra* note 3, at 142. A bill approved by the House of Representatives would prohibit members of the governing board and committees of contract markets to vote on any rule in which the member or the member's firm had a direct financial interest. *See* H.R. REP. No. 102-6, 101st Cong., 2d Sess. 44 (1991).

Concerns with the decisionmaking processes of the exchanges and their effects on the public continue. Recently, one exchange proposed to prohibit using grain grown outside the United States to meet futures contract delivery requirements—a proposal that has foreign policy implications. *See* Taylor, *CBOT May Bar Grain Grown Outside the U.S.*, Wall St. J., Apr. 15, 1991, at C1, col. 6. It has also been suggested that the exchanges should act to stop wrongdoing on their floors instead of heckling federal prosecutors after some of the sting trials were unsuccessful. *See* Greising, *A Hot Tip For Chicago's Exchanges: Clean House*, BUS. WK., Apr. 1, 1991 at 72. In the latter regard, a federal judge in Chicago found the

Concerns with conflicts of interest often result in criticism of the exchanges even when they purport to act in an enlightened manner. For example, the CFTC faced a crisis in the soybean market in the summer of 1988, following a drought. A large foreign company had purchased soybean futures contracts that were alleged to have exceeded the amounts of available deliverable supplies in Chicago. Some members of the Chicago Board of Trade expressed concern that the market was being manipulated. The CFTC took no action, but the Chicago Board of Trade ordered the company to engage in liquidation trading only. The company later charged that the Chicago Board of Trade had acted in the self-interest of its members rather than in its role as a self-regulatory body.[144] Litigation on that issue continues.

The perception of conflict of interest on the part of the exchanges is a real one. The exchanges are for the most part governed by their floor members who are exposed to a welter of conflicts of interest. Moreover, floor members are massed in a single location and, therefore, they have the ability quickly to command initiatives and to remove from office those who offend their interests. Floor members consisting of so-called "locals" and "independent" floor brokers also use their mass to control exchange appointments and policy. Indeed, candidates for the board of governors are generally selected by their predecessors.[145] In those instances where the board's selections do not appear to have the floor interests in mind, the floor members may select their own candidates by petition.[146] As a conse-

conduct of one exchange to be "outrageous" after it expelled traders cooperating with the government in the Chicago sting operation while allowing non-cooperating traders to continue to trade. *Futures Trader Mosky Receives a Sentence of Four Months in Prison*, Wall St. J., July 17, 1991, at C16, col. 6.

144. *See* Markham, *supra* note 9, at 350-52; *see also Ferruzzi Fails in Attempt to Halt CBT Soybean Proceeding*, 23 Sec. Reg. & L. Rep. No. 34, Aug. 23, 1991, at 1278. The exchanges also suffered criticism when they attempted to restrict the size of large speculators on the silver markets during the silver crisis of 1980. It was charged that they were changing the rules in the middle of the game. *See* INVESTIGATIVE REPORT OF THE CFTC DIVISION OF TRADING AND MARKETS, THE SILVER MARKET OF 1979/1980: ACTIONS OF THE CHICAGO BOARD OF TRADE AND THE COMMODITY EXCHANGE, INC. (1985); *see also Silver Prices and The Adequacy of Federal Actions in The Marketplace, 1979-80, Hearings Before the Subcommittee of the House Committee on Government Operations*, 96th Cong., 2d Sess. 281-83, 303 (1980).

In BROKERS AND BAGMEN, *supra* note 3, at 70, 148, the authors assert that a small exchange in Chicago—the Mid-American Commodity Exchange—acted aggressively to enforce its rules, to the extent that its attorney fees required it to merge with the Chicago Board of Trade. The independence and aggression of that exchange may be due to the fact that its management was completely restructured after the CFTC, in a rare moment of forceful action, found that the exchange's management was riddled with conflicts of interest. Among other things, the CFTC required outside directors to be added to the board, required a professional staff to be hired and an affirmative rule enforcement program to be implemented. *See In re* Mid-American Commodity Exch., Inc., [1977-1980 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 20,464 (C.F.T.C. 1977).

145. *See* CHICAGO BOARD OF TRADE, RULES AND REGULATIONS, §§ 100.00, 102.00, 156.00 [hereinafter CBT RULES & REGS.].

146. *Id.* at § 102.00; *see also* McMurray, *Sandner Regains Merc Chairmanship, Defeating Rival Linked to Melamed*, Wall St. J., Jan. 17, 1991, at C8, col. 5 (reporting that exchange

quence, the public has only token representation in the form of outside public directors on the exchanges' boards of directors.[147] In contrast, after scandals on the securities exchanges, efforts were made to strengthen public representation on those exchanges. Today, at least half of the boards of directors of most securities exchanges are public directors who represent the interests of the public rather than the exchange members.[148]

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member rode "wave of member discontent to regain the chairmanship of the Chicago Mercantile Exchange").

147. The Chicago Board of Trade, for example, provides for four nonmember directors who are nominated and approved by the Board and eighteen elected exchange members. CBT RULES & REGS., *supra* note 145, at § 120.00. The Chicago Mercantile Exchange provides for 27 exchange members on its board and only five persons who are not members. RULES OF THE CHICAGO MERCANTILE EXCHANGE § 210.

148. Glickman & Russo, *Business Forum: Commodity Exchanges and Self-Governance; Look Beyond the 'Pit's' For Directors*, N.Y. Times, Oct. 28, 1984, § 3, at 3, col. 1. The board of the NYSE, for example, is composed of twelve public members, twelve industry members and two exchange officials. *Big Board Nominates Two New Candidates, 10 Others As Directors*, Wall St. J., Mar. 12, 1991, at B5, col. 1.

The securities industry has long focused on the need to have independent representation on boards of directors in companies that deal with the public in stock offerings or investments. For example, the Investment Company Act of 1940 requires 40% of an investment company's board of directors to be composed of persons who are not "interested persons" of the company. 15 U.S.C. § 80a-10 (1988). Large stockholders are also attempting to expand outside director representation in many publicly held corporations. *See* Barnard, *Institutional Investors and the New Corporate Governance*, 69 N.C.L. REV. 1135 (1991); Ferguson, *Filling in the Blankety-Blanks on Proxies*, Wall St. J., June 25, 1991, at A23, col. 4; Lublin, *Tense Times, More Chief Executives Are Being Forced Out by Tougher Boards*, Wall St. J., June 6, 1991, at A1, col. 6; Stevenson, *Battling For Shareholder Rights*, N.Y. Times, June 6, 1991, at D1, col. 3; Neff, *Manager's Journal, Shareholder Muscle Cutting Into Corporate Fat*, Wall St. J., Mar. 25, 1991, at A10, col. 3; Schellhardt, *More Directors Are Recruited From Outside*, Wall St. J., Mar. 20, 1991, at B1, col. 6; *but see* White, *New York's Regan to Pensions: Hands Off*, Wall St. J., Sept. 13, 1991, at C1, col. 3 (reporting that trustee of large pension fund does not believe that pension fund managers are qualified to interfere in corporate affairs simply because they are large shareholders). In addition, a tentative draft of the American Law Institute's Principles of Corporate Governance suggests that the board of directors of every large publicly held corporation should have a majority of directors who have no significant relationship with the company's senior executives and that large corporations should have audit committees composed of directors who are not employed by the corporation. *See* AMERICAN LAW INSTITUTE, PRINCIPLES OF CORPORATE GOVERNANCE, PART III §§ 3.03-.04 (Tent. Draft No. 2, 1984). This report also notes that the NYSE requires companies listed on that exchange to have a minimum of two independent directors. *See id.* One former SEC chairman would go even further and require that the boards of directors of public companies be composed only of independent directors and the company's chief executive officer. *See* Address of Harold Williams, Corporate Accountability, 5th Annual Securities Regulation Institute, San Diego California (Jan. 18, 1978); *see also* Hahn & Manzoni, *The Monitoring Committee and Outside Directors' Evolving Duty of Care*, 9 LOY. U. CHI. L.J. 587 (1978). Other commentators, however, have suggested that the board should include additional company management. *See Responsibilities of Corporate Officers and Directors Under Federal Securities Laws*, Fed. Sec. L. Rep. No. 1438, Part II at 18 (Mar. 15, 1991).

Smaller companies are increasingly using outside directors. Marsh, *More Small Firms Are Employing Outside Directors*, Wall St. J., June 11, 1991, at B2, col. 3. Corporations with outside directors also have a better ability to defend corporate actions when it is charged that

In other instances where floor interests are not taken strictly into account, the floor often acts virtually as a plebiscite by circulating petitions on the floor and demanding that proposals be adopted by the board of governors or that rules be changed or enacted to preserve their interests.[149] The result is that the interests of members are given primacy over the interests of all others. The paramount interest of members, obviously, is to protect their own financial interests.

The committee system employed by the commodity exchanges for their administration is also in need of reform. Although the exchanges have professional staffs, they are, in fact, governed by exchange committees composed of exchange members. The exchange committees have overall oversight in the board of directors or governors,[150] which, as noted are also composed principally of exchange members. Exchange committees are often riddled with conflicts of interest and by persons ill-equipped to manage the affairs of an exchange. Those committees are responsible for enforcing exchange rules and disciplining other members. However, because they do not often have lawyers as members, their actions are often marked by due process violations and the rules they enforce are often so broad or obscure as to allow any conduct to be deemed offensive.[151] Committee members

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there was self dealing by corporate officers or other breaches of fiduciary duty. *See e.g.*, Panter v. Marshall Field & Co., 646 F.2d 271, 295 (7th Cir. 1981); Solash v. Telex Corp., [1987-1988 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 93,608 (Del. Ch. 1988); Revlon, Inc. v. MacAndrew & Forbes Holdings Inc., 506 A.2d 173 (Del. Super. Ct. 1986); Moran v. Household Int'l, 500 A.2d 1346 (Del. Super. Ct. 1985); Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946 (Del. Super. Ct. 1985). In any event, increased representation of the outside directors in public companies seems to be a long term phenomenon. SEC STAFF REPORT ON CORPORATE ACCOUNTABILITY (Sept. 4, 1980).

149. *See* BROKERS AND BAGMEN, *supra* note 3, at 119 (stating that Chicago Exchange is operated for benefit of floor brokers); CBT RULES & REGS., *supra* note 145, at § 109.00; *Changing of the Guard*, FUTURES & OPTIONS WORLD, Jan. 1991 (contrasting Chicago Mercantile Exchange which has "traditionally been a member-run organization" with NYSE which has a broad array of interests represented on its board, including twelve public members).

150. The most important of these committees is generally referred to as the Business Conduct Committee. It is responsible for disciplining members for violation of exchange rules. *See* CBT RULES & REGS., *supra* note 145, at § 542.00. The committee in next order of importance is the Floor Conduct or Floor Governors Committee, which is responsible for proposing rules for trading activities on the floor of the exchange and for administering the conduct of members trading on the floor. *See id.* at § 543.00.

151. The CFTC has reversed numerous self-regulatory disciplinary actions for improper procedures. *See, e.g.*, Siegel v. Board of Trade, 2 Comm. Fut. L. Rep. (CCH) ¶ 24,983 (C.F.T.C. 1991) (holding that chairman of disciplinary committee improperly acted as prosecutor on appeal to Board of Governors, that there were gaps in record on appeal, that improper inferences were drawn and that unreliable hearsay evidence was relied upon by exchange); Laken v. Chicago Mercantile Exch., 2 Comm. Fut. L. Rep. (CCH) ¶ 24,968 (C.F.T.C. 1990) (holding that respondent was not provided required discovery materials and that prosecutorial and adjudicative roles of exchange members staff were improperly mixed); ABC Commodity Futures Options Inc. v. National Futures Ass'n, 2 Comm. Fut. L. Rep. (CCH) ¶ 24,911 (C.F.T.C. 1990) (holding that exchange had applied improper procedures); Brotman v. Commodity Exch., Inc., 2 Comm. Fut. L. Rep. (CCH) ¶ 24,907 (C.F.T.C. 1990)

also devote much time and effort to assure that their rules preserve the value of their membership. To cite one example, the Chicago Board of Trade does not allow registered professionals on its floor and sharply limits the role of clerks on the floor who assist members. This is to assure that the value of membership is not reduced by allowing nonmember professionals to have access to the floor.[152]

5. *More Public Representation is Needed*

Representation on the futures exchanges should be modified so that public members serve on disciplinary committees, on exchange committees that propose regulations and on the governing bodies of the exchanges, including the executive committee and board of governors. The election process for the board of governors should also be changed to assure that public directors are indeed independent on the floor. Control of exchange committees should be placed in the hands of professional management at the exchanges and greater oversight of their operations should be undertaken by the CFTC to assure that self-regulation is working in the public interest, and not solely in the interests of exchange members.

(holding that exchange used improper procedures in imposing disciplinary sanctions); Fusfield v. Financial Instrument Exch., 2 Comm. Fut. L. Rep. (CCH) ¶ 24,906 (C.F.T.C. 1990) (finding record before exchange disciplinary body to be materially misleading); Redel v. Coffee, Sugar & Cocoa Exch., 2 Comm. Fut. L. Rep. (CCH) ¶ 24,897 (C.F.T.C. 1990) (reversing exchange disciplinary decision proceeding for improper procedures); Mandelbaum v. New York Mercantile Exch., 2 Comm. Fut. L. Rep. (CCH) ¶ 24,896 (C.F.T.C. 1990) (reversing exchange disciplinary decision because of improper procedures); *In re* First Commodity Corp. of Boston, 2 Comm. Fut. L. Rep. (CCH) ¶ 24,850 (C.F.T.C. 1990) (reversing exchange proceeding for second time); *In re* Bryant, 2 Comm. Fut. L. Rep. (CCH) ¶ 24,847 (C.F.T.C. 1990) (affirming registration denial after second appeal); *In re* Horn, 2 Comm. Fut. L. Rep. (CCH) ¶ 24,836 (C.F.T.C. 1990) (reversing for second time decision allowing industry leader to remain in business after being convicted of felony); *In re* Lama, [1987-1990 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 24,294 (C.F.T.C. 1988) (finding error in exchange's failure to consider relevant evidence); Laybov v. Chicago Board of Trade, [1987-1990 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 23,942 (C.F.T.C. 1987) (directing exchange to reconsider penalty); *In re* Horn, [1986-1987 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 23,406 (C.F.T.C. 1986) (reversing decision allowing registration of convicted felon who had been former industry leader); Grabarnick v. National Futures Ass'n, [1986-1987 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶¶ 23,270-72 (C.F.T.C. 1986) (finding that exchange had failed to explain decision); *In re* Morrissey, [1986-1987 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 22,961 (C.F.T.C. 1986) (holding that suspension imposed by exchange was not reasonable); *In re* Missouri Farmers Ass'n, [1984-1986 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 22,310 (C.F.T.C. 1984) (holding that policy applied by exchange had not been properly adopted, but also that it was moot on other grounds); *In re* Spilatro (C.F.T.C.), *noted in* Seifert, *Commission to Review Exchange Actions*, 9th Annual Commodities Law Institute, Sept. 25-26, 1986 (holding that exchange failed to specify reasons for denying membership to applicant). However, the problem with fair procedures may not be limited to the commodity exchanges. *See* Lowenfels, *A Lack of Fair Procedures in the Administrative Process: Disciplinary Proceedings at the Stock Exchanges and the NASD*, 64 CORNELL L. REV. 375 (1979); *but see* Poser, *Reply To Lowenfels*, 64 CORNELL L. REV. 402 (1979).

152. *See* Chicago Board of Trade Regulation 301.05 and app. 3B.

A bill approved by the House of Representatives in 1989 would have required that at least twenty percent of the members of exchange board of governors be outside directors—*i.e.*, public representatives who do not have affiliations with the exchange.[153] This proposal falls well short of the goal of removing control of the exchanges from the floor members. A more effective approach would be to limit floor representation to twenty percent and require at least fifty percent of the board members to be independent or public directors. The remaining thirty percent would represent other interests on the exchange such as the brokerage firms.

These proposals may seem mild, but any effective reform turns upon their implementation. Such changes would shift political control of the exchanges to a more public-minded group than the individual members who are exposed to the temptation of enriching themselves at the expense of the public. Public minded directors can devote the energies and resources of the exchange to modernizing operations, and they can expend funds on improving surveillance and enforcement mechanisms rather than supporting lobbyists to frustrate needed legislative reforms or to carry out feuds with the CFTC. To date, the exchanges have used their monopoly positions to block needed reforms and regulation because their self-interest so dictates. By transferring control to public directors, reform measures can be viewed from the more objective viewpoint of the public interest, instead of simply from that of monopoly preservation.[154]

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153. *See* H.R. REP. No. 236, 101st Cong., 1st Sess. 6 (1989). One should not expect that a requirement for independent directors will result in radical reformers being appointed to exchange boards. The appointment of outside directors is controlled by management and they will generally appoint individuals they believe are compatible with management views. *See* W. CARY & M. EISENBERG, CORPORATIONS-CASES AND MATERIALS 969-70 (6th ed. 1988); M. MACE, DIRECTORS: MYTH AND REALITY (1971); Mace, *The President and Board of Directors*, HARV. BUS. REV., Mar.-Apr. 1972, at 37; Monks, *The Oxymoron in the Boardroom*, N.Y. Times, May 5, 1991, at F13, col. 4; *see also* Brudney, *The Independent Director—Heavenly City or Potemkin Village?*, 95 HARV. L. REV. 597 (1982); *see also* Hazen, *The Corporate Persona, Contract (and Market) Failure, and Moral Values*, 69 N.C.L. REV. 273, 283-84 (1991). Nevertheless, mavericks do sometimes appear. *See* Bailey, *Eagleton Accuses Chicago Merc's Leaders and Quits*, N.Y. Times, Nov. 8, 1989, § 3, at 17, col. 1 (reporting on resignation of outside director of commodity exchange and on director's charge that exchange's enforcement policies were improper); Eagleton, *Chicago's Markets: Corrupt To The Core*, N.Y. Times, Nov. 14, 1989, at A31, col. 2 (same); Vise, *Eagleton Resigns Merc Post, Blasts Officials at Exchange*, Wash. Post, Nov. 8, 1989, at B1, col. 5 (same). Moreover, outside directors will be at least one step removed from the pressures of the floor interests and they can add needed objectivity and balance. *See* Bierrie, *Don't Blame Program Trading—Blame the Market*, N.Y. Times, Dec. 6, 1989, at A30, col. 6 (discussing role of outside director on commodity exchanges).

Indeed, even opponents of additional government regulation of the futures exchanges have advocated broader representation on exchange boards. *See* Lower, *Disruptions of the Futures Market: A Comment on Dealing with Market Manipulation*, 8 YALE J. ON REG. 391, 401 (1991); *but see Outside Directors Tied to Skimpy Returns*, Wall St. J., July 30, 1991, at B1, col. 1 (suggesting that companies controlled by outside directors may have reduced profitability).

154. The best example of the exchanges' role in frustrating reform is the fifteen year odyssey that the CFTC has undergone to strengthen audit trail requirements on the exchanges

This proposal is critical but it faces a monumental hurdle that may be referred to simply as the "franchise" problem. Exchange members presently pay large amounts for their seats—often several hundred thousand dollars.[155] Individual floor members view this as a purchase of a franchise. Their control of exchange governing bodies and committees all have one overriding objective—the preservation of that franchise. Through control of the governing bodies of the exchanges these franchisees also seek to assure that the public pays for the continuation of that franchise. For example, most exchanges charge customers a transaction fee that is many times more than the transaction fees paid by exchange members.[156] The ostensible basis for

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and to impose regulations that would remove the appearance of conflict by dual trading of floor brokers (traders who trade both for their own account and for customers). *See* BROKERS AND BAGMEN, *supra* note 3, at 135-36, 150-51; Markham, *supra* note 93.

155. Efforts to increase representation of outside directors on commodity exchange boards of directors can be expected to meet strong opposition. *See Letter to the Editor, Commodity Governance*, N.Y. Times, Nov. 25, 1984, § 3, at 12, col. 1 (wherein exchange member objects strongly to proposal to increase public directors on commodity exchanges). The attitude expressed by one defendant in the Chicago sting operation is revealing. He stated, "[Expletive] the customers . . . . We should have the advantage. That's why we have the membership . . . . Let them buy a [expletive] seat for $500,000 and put their money on the line like the rest of us." McMurray, *A Losing Proposition, Futures Trading is Usually a No-Win Game for the Small Investor*, Wall St. J., Oct. 19, 1990, at R4, col. 1. According to the testimony in one of the Chicago sting operation trials, traders are willing to pay several hundred thousand dollars for a seat on the Chicago board of Trade so that they can enjoy the "edge." Novak Testimony, *supra* note 78, at 4300-01.

For a discussion of efforts by the commodity futures exchanges to protect their "franchises," see Gold, *A Tale of Two Cities, The New York and Chicago Exchanges Battle for Control of Stock Futures Trading*, FIN. WORLD, Oct. 16, 1990, at 42; Eichenwald, *Marketplace: What Constitutes An "Exchange"?*, N.Y. Times, Feb. 8, 1991, at D6, col. 3. The commodity exchanges' efforts to preserve the franchise have resulted in a stalemate for legislative reform while "[t]he public sits in the middle" and while "important reforms [are] being killed in the cross-fire." *A Reform That Failed*, Wash. Post, Oct. 29, 1990, at A14, col. 1.

156. *See* Chicago Board of Trade Rule 450.02 (charging two cent per side transaction fee for exchange member transactions and 50 cents per side transaction fee for nonmembers). Recently, the Chicago Mercantile Exchange announced that it would reduce its twenty-five cent per transaction charge for members to seven cents. Taylor, *Chicago Merc Sets Reduction in Fees on Futures Trades*, Wall St. J., Jan. 8, 1991, at C15, col. 1. It will reduce the charge to public customers to seventy cents from seventy-five cents. *Id.* Some members on the Chicago Mercantile Exchange had wanted even a bigger cut in member fees. *Chicago Merc's Members Reject Traders' Fee Plan*, Wall St. J., Jan. 25, 1991, at C12, col. 4. In contrast, the exchanges have vigorously fought any effort to impose a service fee that could be used to help pay for regulatory costs. *See* J. MARKHAM, *supra* note 7, at 110; Horwitz & Markham, *Sunset on the Commodity Futures Trading Commission: Scene Two*, 39 BUS. LAW. 67, 80-81 (1983); McMurray, *New Plan to Tax Futures Traders Isn't a Sure Loser*, Wall St. J., Feb. 7, 1991, at C1, col. 3.

The CFTC has stated that it will not seek to regulate fees charged by the exchanges. *See* Davis & Partners, Ltd. v. New York Futures Exch., 2 Comm. Fut. L. Rep. (CCH) ¶ 24,816 (C.F.T.C. 1990). In another context, the CFTC stated that it does not seek to regulate the level of fees that a customer may agree to pay to commodity professionals even if they are unconscionable or *per se* fraudulent. Johnson v. Fleck, 2 Comm. Fut. L. Rep. (CCH) ¶ 24,957 (C.F.T.C. 1990); *accord* Macurdy v. Byrne, 2 Comm. Fut. L. Rep. (CCH) ¶ 25,083 (C.F.T.C. 1991).

justifying this disparity is the claim that exchange members need low transaction fees so that they can more easily trade in high volume and add liquidity to the market place. That is, indeed, true but it hardly justifies imposing a disparate fee on the public for whom these markets are held open and who also add liquidity. Its justification also overlooks the fact that these exchange fees are used in large measure to perpetuate the franchise, by lobbying against reform and frustrating the CFTC, to the detriment of the public.

Elimination of the franchise would also bring the United States in line with current reform efforts in Europe. In this regard, the European Commission's draft investment service directive would require EC member states to nullify any rules of exchanges that limit the number of persons admitted to membership. Not surprisingly, the European exchanges have opposed this on the grounds that they should have the right to control access to their floors, which are limited in space.[157] The space problem is a constraint particularly in the futures markets in their present form. But that should not be used as a reason to perpetuate a monopoly. To the contrary, if the franchise is eliminated, the exchanges will have an incentive to expend funds on the expansion of facilities or to automate in a way that allows greater participation, rather than to lobby against reform or engage in quarrels with the CFTC. Greater access to the market place on equal terms by more persons would also assure greater competition. To the extent facilities become overtaxed, an incentive will exist for competing exchanges to develop and provide even further competition.

Existing members will, of course, contend that disenfranchisement will mean that their capital assets are being diminished and that this would be an unfair taking of their property—property for which they paid several hundred thousand dollars. However, the value of these memberships is simply a reflection of their monopoly value—*i.e.*, only a limited number of such memberships are made available by the exchanges in exercising their statutory monopoly under Section 4 of the Commodity Exchange Act. Nevertheless, recognition should be given to the fact that many individual members have literally expended their entire life's savings or incurred heavy debts in order to obtain a seat. Those concerns could be diminished, however, by extending the period over which additional memberships would

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157. The proposed investment directive states that:

> Host Member States shall ensure that investment firms which are authorized to provide broking, dealing or market-making services in their home Member States can enjoy the full range of trading privileges normally reserved to members of stock exchanges and organized securities markets of host Member States where similar services are provided.

Commission Proposal for a Council Directive on Investment Services in the Securities Field, tit. 4, art. 10, ¶ 3, 1989 O.J. (C 43) 7, 10; *see also Financial Services in Europe, Single, But Not Level*, ECONOMIST, Feb. 23, 1991, at 83; *French Stock Brokers, Nanny Picks Up The Pieces*, ECONOMIST, Jan. 12, 1991, at 73-74 (reporting that French brokers lost their monopoly on exchange seats and foreign brokers will be given equal access to the French market).

be sold at more affordable prices. This would allow an opportunity for facilities to be expanded, and the prices paid for the existing franchises could be amortized over the remaining life of the monopoly franchise. Alternatively, the exchanges could use a portion of revenues from new seat sales to pay prior membership holders as a recognition of the diminishment of their value. At worst, such payments would be a small tribute to pay for the reform that is needed. Whatever happens, continued restriction of access to the market place should be eliminated or reduced to the maximum extent possible.

III. Floor Operations Need to be Restructured

1. *An Automated Small Order System is Needed*

The commodity exchanges have long needed an automated small order execution system. Indeed, several years ago, an official for a large brokerage firm urged that an automated order system for small orders be developed in the commodity futures industry because of customer dissatisfaction with the chaotic order filling system on the exchanges. That proposal set off a storm of controversy and it was never brought to fruition.[158] The CFTC

158. *See Merrill Commodities Chief Proposes Automated Executions*, Sec. Wk., Sept. 28, 1981, Financial Futures Commodity Report, at 8. The official later retreated somewhat from this position, but still stressed the need for improved order handling. *See* Maidenberg, *Futures/Options; Automation and Trading*, N.Y. Times, Dec. 10, 1984, at C4, col. 3; Maidenberg, *Futures/Options: Big Growth in Orders Paralyzing Trading Pits*, N.Y. Times, March 19, 1984, at D6, col. 3. The brokerage firm official sought to avoid controversy in making this proposal by suggesting that floor brokers would still receive brokerage fees for executions conducted through the black box. It was thought that this tribute, which would be a payment for doing nothing, would be worth a more orderly order filling process. The Chicago sting operation suggests that the floor brokers had more in mind than just floor commissions when they opposed this proposal.

After the black box proposal was blocked, the brokerage firms began utilizing their own employees as floor brokers to execute their customer orders. This too was met by a storm of opposition on the exchanges because floor brokers were afraid that this would reduce the value of their franchise. Maidenberg, *Futures/Options; Rules Dispute Spread Feared*, N.Y. Times, June 11, 1984, at D2, col. 1.

Interestingly, a bill approved by a Senate committee would make brokerage firms secondarily liable to their customers for damages caused by floor brokers on the exchange, even if the floor brokers are not their own employees. Brokerage firms would also be liable for punitive damages for the activities of such "independent" brokers if it were shown that the brokerage firm intentionally selected a floor broker with the intent to assist or facilitate the floor broker's violation. This appears to be simply an effort to find a deep pocket for the fraudulent activities of undercapitalized floor brokers on exchanges. *See* S. Rep. No. 101, 101st Cong., 1st Sess. 15 (1989); *see also* Rotter v. Stotler & Co., 2 Comm. Fut. L. Rep. (CCH) ¶ 24,621 (C.F.T.C. 1991) (liability for activities of independent floor broker imposed on brokerage firm); Buran v. Lerman, 2 Comm. Fut. L. Rep. (CCH) ¶ 24,874 (C.F.T.C. 1990) (holding brokerage firm liable for activities of independent floor broker); *but see* Balfour Maclaine, Inc. v. National Coin Exch., 697 F. Supp. 835 (E.D. Pa. 1988); Johnson v. Chilcott, 658 F. Supp. 1213, 1218 (D. Colo. 1987); Fustok v. ContiCommodity Services, Inc., 618 F. Supp. 1082, 1088 (S.D.N.Y. 1985); Sherman v. Sokoloff, 570 F. Supp. 1266, 1270-71 (S.D.N.Y. 1983).

also has not made any effort to urge the exchanges to develop an automated small order execution system. Sadly, the effect of that failure is reflected in the Chicago sting operation in that most of the orders involved there were small in size. If a small order execution system had been in place at the Chicago exchanges, much of the fraud exposed by the Chicago sting would have been avoided. Those orders could have been executed automatically and at competitive prices. Unfortunately, there is still no effort underway to establish a small order execution system for commodity futures orders of a small size. That shortcoming should be corrected.[159]

Presently, the stock exchanges and the NASD have automated order execution systems for small customer orders. These include the Super DOT system of the New York Stock Exchange and the SOES system of the NASD.[160] New information technology is also being developed in the securities industry that would allow small orders to be automatically queued, bids and offers matched, and trades executed. These systems will also allow executed trades to be moved through final settlement and they would create an audit trail.[161]

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159. *See* Markham, *There's Trouble in the Futures Trading Pits*, Legal Times, June 3, 1991, at 26; *see also* BROKERS AND BAGMEN, *supra* note 3, at 311-12 (suggesting that computers be used to match retail customer orders). The problems exposed by the Chicago sting operation and other inefficiencies in executing orders were well known even before the sting operation. Indeed, it was charged that cheating of customers was institutionalized. *See* BROKERS AND BAGMEN, *supra* note 3, at 71 (prior to public disclosure of sting operation, one federal judge, somewhat intemperately, charged that one Chicago exchange was a "cesspool" where "sham" trades were commonplace); Cohen & Jouzaitis, *S&P Futures Pit Giving Merc Black Eye*, Chi. Tribune, Feb. 22, 1987, § 7, at 1, col. 2.

160. In the 1960s, the order execution process on the securities exchanges was similar to the methodology used on commodity futures exchanges in that orders were transmitted to brokerage firm desks on the floor of the NYSE and then hand carried for execution from the desk to the specialist post. On commodity exchanges there is no specialist. There, orders are transmitted to brokerage firm desks on the floor and then carried by "runners" or "flashed" by hand signal to the pit for execution. This is a manually intensive process. The NYSE developed its Designated Order Turnaround (DOT) system to allow small market orders to be directly routed from the member firm's branch office to the applicable specialist post, thus eliminating the necessity of transmitting the orders to a desk on the floor and manually transmitting them to the specialist post. The NYSE enhanced this system in the 1980s by allowing pre-opening orders to be paired off, leaving only the imbalance for execution by the specialists. The NYSE also enhanced the system by allowing automatic routing of limit orders to a limit order book. Thereafter, automated executions were permitted where the NYSE was reporting the best quote. The specialist limit order book was also automated. Other exchanges developed small order execution systems as well. *See* OCT. 1987 MARKET BREAK, *supra* note 112, at xxii, 7-16 to 7-38.

The NASD's Small Order Execution System (SOES) was designed to allow small orders to be executed automatically at the best bid or ask price. A problem that developed with the SOES system was that the market makers could withdraw at any time and re-enter without limitation. During the Stock Market Crash of 1987 many market makers withdrew from the system. NASD is now imposing minimal requirements to assure continued participation in the system during market breaks. *See id.* at xxiv, 9-12 to 9-19.

161. *See* ELECTRONIC BULLS AND BEARS, *supra* note 111, at 3. This is not to suggest that the entire exchange process must be automated, because complete automation could impair

It should be noted, however, that these automated systems may not be a complete panacea. Automated order systems in the securities industry have also proved faulty in high volume moments such as the Stock Market Crash of 1987; although improvements are being made to assure better performance.[162] Automated order execution systems may also themselves be subject to abuses and lack of regulation, as where there is a lack of security over the system or where participants are not regulated.[163] Automated order execution may also slow up order executions. Today, many orders are "arbed" or "flashed" into the pits. This means they are transmitted into the pits from order desks on the floor by hand signals so that they may be more rapidly executed.[164] Inputing information into a terminal may slow

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liquidity. *See* Markham, *supra* note 93, at 45 (discussing concerns that market "feel" may be lost if trading is completely computerized); Behrmann & Angrist, *Men vs. Machines in Bund-Trading Duel*, Wall St. J., Dec. 20, 1990, at C1, col. 3 (discussing differences between futures trading in London and Germany: Germany has automated system, while London, which maintains its lead in trading, has open outcry system); *but see* Angrist, *Futures Trade on Screens—Except in U.S.*, Wall St. J., May 21, 1991, at C1, col. 3 (reporting that "most traders believe that, ultimately, buying and selling via computer screen will be substantially cheaper than the 'open-outcry' method of trading," but that U.S. floor traders are slowing process); *see also* Andres & Torres, *The New Market, Computers Bypass Middleman and Stir Controversy*, Wall St. J., Aug. 28, 1991, at A1, col. 6 (discussing concerns caused by automated trading systems); Herman, *The Next Voice These Traders Hear May Be a Computer*, Wall St. J., May 29, 1991, at B8, col. 1.

162. *See* OCT. 1987 MARKET BREAK, *supra* note 112, at 7-21, 9-13 to 9-15. The performances of these systems were improved during the market break of 1989. *See Report of SEC Division of Market Regulation, Market Analysis of October 13 and 16, 1989*, [Current Binder] Fed. Sec. L. Rep. (CCH) ¶ 84,706 (Dec. 1990). Nevertheless, the securities industry has also been the subject of criticism for their failure to implement high technology that would make their operations more efficient and reduce market problems. *See* Kerr & Maguire, *Program Trading—A Critical Analysis*, 45 WASH. & LEE L. REV. 991, 1030 (1988); *see also* Angrist, *Futures Trade on Screens—Except in U.S.*, Wall St. J., May 21, 1991, at C1, col. 3 (reporting that computerized trading systems used abroad for futures instruments have experienced delays in high volume trading).

163. *See* Sundel & Blake, *Good Concept, Bad Executions: The Regulation and Self-Regulation in Automated Trading Systems in United States Futures Markets*, 85 NW. U.L. REV. 748 (1991); *see also Tomorrow's World for Traders*, EUROWEEK, Nov. 16, 1990 (discussing security concerns in computerized trading system). An automated system may also cause difficulties because errors can not be worked out informally. However, it was the informal system of resolving errors on the commodity futures exchanges that allowed the many fraudulent transactions exposed by the Chicago sting operation. *See* Miller, *Who Takes Blame When Trades Short-Circuit?*, Wall St. J., Nov. 20, 1990, at C1, col. 3.

Efforts are being made on an international basis to establish effective regulation over computerized trading programs. *See IOSCO Adopts Principles for Overseeing Electronic Trading*, FIA REV., Nov./Dec. 1990, at 14; *International Organization of Securities Commissions, Report of The Technical Committee, Screen-Based Trading Systems for Derivative Products*, 2 Comm. Fut. L. Rep. (CCH) ¶ 25,035 (1990). The CFTC is participating in this effort. CFTC, *Policy Statement Concerning the Oversight of Screen-Based Trading Systems*, 2 Comm. Fut. L. Rep. (CCH) ¶ 24,953 (1991).

164. *See* Ashman Testimony, *supra* note 82, at 5541-42 (discussing fact that written orders may not be disclosed, while orders flashed into pit are disclosed to everyone); COMMODITY TRADING MANUAL, *supra* note 1, at 36 (discussing flashing of orders in pits).

that process slightly. But, it is doubtful whether small orders need to be flashed to the pits, and because locals on the floor can pick off flashed orders—*i.e.*, flashing provides locals with greater knowledge of the order flow—locals can more quickly predict the course of the market from the nature of the orders being entered. This is unfair to customers and to other traders. It provides a competitive advantage that is due solely to the monopoly position of the locals.

Another problem that has plagued the CFTC for many years, and which has been cited as a leading factor that allowed brokers to engage in the widespread fraud that was uncovered by the Chicago sting operation, is the lack of an adequate audit trail. An audit trail allows the CFTC to recreate trading to determine whether orders were executed competitively and whether customers received an appropriate price. Over a period of some 15 years, the CFTC has attempted to tighten the audit trail by requiring the timing of orders at various stages in the process. The exchanges, after years of prodding by the CFTC, have also developed computerized programs that enhance their ability to time the execution of orders in the pits.[165] Although there is still no requirement that the trades be time stamped, several exchanges are attempting to create hand-held computers that will time orders so as to alleviate this problem.[166]

If the small order execution process is automated, those orders would be timed and transmitted automatically by a computer to the floor of the exchange for entry. This would also help guard against the types of fraud incurred by the Chicago sting operation and against fraudulent order allocations—a common problem of fraud in the industry. For example, a frequent fraud claim is that when the trades are "winners" customer trades

165. *See* Markham, *supra* note 93; Taylor, *At Long Last, High-Tech Comes to Chicago's Commodities Pits*, Wall St. J., July 11, 1991, at C1, col. 4. Congress may mandate further efforts on timing of executions. *See* Block, *Closing Overnight of Commodities Voted By House*, Wall St. J., March 6, 1991, at C6, col. 6. The CFTC is also continuing to prod the exchanges into tightening up their audit trails. *See* Letter from Andrea M. Corcoran, Director, CFTC Division of Trading and Markets to Thomas R. Donovan, President, Mid-America Commodity Exchange (Mar. 8, 1989).

166. *See New Computerized Order-Entry Device Unveiled by Comex*, Wall St. J., Oct. 28, 1989, at C16, col. 6.; *Money Line: Futures Plan*, U.S.A. Today, Aug. 17, 1989, at B1, col. 1. The exchanges have argued that provisions in proposed legislation that would tighten audit trail requirements would hinder them in developing electronic trading systems. *See* Salwen, *House Panel Votes to Curb Futures Trading*, Wall St. J., Feb. 20, 1991, C1, col. 3.

A bill approved by the House of Representatives would direct the CFTC to conduct a study to determine whether its rules and regulations are affecting the competitiveness of contract markets. *See* H.R. REP. No. 102-6, 101st Cong., 2d Sess. 46 (1991). The House Bill would also require the CFTC to conduct a study to determine whether it is feasible to conduct trading in futures and options by computers or other electronic means. *Id.* The purpose of these changes would be to enhance access to the futures and option markets by market participants and improve the ability of the CFTC to audit the activities in those markets and reduce the opportunity for trading abuses. *Id.* The Chicago Board of Trade has announced that it intends to introduce a steel futures contract that will be traded only on computer screens. *New Futures Trading Plan*, N.Y. Times, Aug. 22, 1991, at C12, col. 4.

are allocated after their execution to favored accounts, while when the trades are "losers" they are allocated to less favorable customers.[167] If orders are timed through automated entry, and if the account number must be added before the order can be entered into the pit, the opportunity for fraud and collusion would be much diminished and the audit trail would be much improved. Through such enhancements many concerns with fraud and improper order execution could be reduced substantially. Of course, automated execution systems will require a commitment of capital, which is not a popular prospect in an industry where revenues are shrinking.[168] Nevertheless, the technology now seems available and the need is present for automated entry.

2. *A Large Order Execution System Is Needed*

Another reform that would introduce more competition to the exchanges' present floor monopoly is the creation of large order execution systems. Unlike the securities exchanges, the commodity exchanges and the CFTC have prohibited the positioning of large orders prior to their entry and execution in the pits.[169] In the securities industry such positioning is

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167. The Commodity Exchange Act was amended in 1968 to assure that its anti-fraud provisions prevented such order allocation schemes. *See* 113 CONG. REC. 23,652 (1967); S. REP. No. 947, 90th Cong., 2d Sess. 6 (1968). For examples of cases involving order allocation schemes, see United States v. Nerlinger, [1987-1990 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 24,371 (2d Cir. 1988); Jordan v. Clayton Brokerage Co., [1987-1990 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 24,346 (8th Cir. 1988). The CFTC has also adopted a regulation designed to prevent floor brokers from allocating orders among customers accounts. *See* 17 C.F.R. § 155.2(g); *Adoption of Dual Trading Regulations* [1975-1977 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 20,242 at 21,295 (C.F.T.C. 1976); *see also Stephens Is Awarded Damages in Fraud Suit Against Geldermann*, Wall St. J., Dec. 24, 1990, at 25, col. 1 (describing fraudulent order allocation scheme in which trader placed winning trades in account of his mother, "Academy Award winning actress Mercedes McCambridge").

168. *See* Power, *Brokerages Are Pruning Their Branches*, Wall St. J., June 21, 1991, at C1, col. 3; Pae, *Securities Firms Can Call 1990 Worst Year Yet*, Wall St. J., Apr. 5, 1991, at C1, col. 3; Leckey, *Irresistible Wall St. Hits Immovable Reality*, Chi. Tribune, Feb. 11, 1990, § 7, at 4, col. 1; *Shearson to Cut Commissions It Pays to Brokers*, Chi. Tribune, Nov. 21, 1989, § 3, at 7, col. 1; Widder, *New York to Pay for Wall St. Woes*, Chi. Tribune, Nov. 10, 1989, § 1, at 1, col. 4. Although Wall Street brokerage firm profits have been reduced in recent years, futures trading profits are actually expanding. *See* Tanouye & Taylor, *Futures Trading Appears Headed for Yearly Drop*, Wall St. J., July 1, 1991, at C1, col. 5 (stating that futures trading volume is declining for first time since 1968); Taylor, *Futures Become Hot as Economy Slumps, Sparing Chicago the Fate of Wall Street*, Wall St. J., Dec. 27, 1990, at C1, col. 3 (noting that, nevertheless, futures trading volume is down some two percent from 1989 and that Chicago Mercantile Exchange announced that it would eliminate 52 staff jobs). The brokerage firms, however, are seeing increased profitability in recent months. *See* Siconolfi, *Merrill Lynch and Smith Barney Post Record Net*, Wall St. J., July 17, 1991, at C1, col. 5.

169. 13 J. MARKHAM, COMMODITY REGULATION: FRAUD, MANIPULATION AND OTHER CLAIMS § 14.02 (1987); *see also In re* Gilchrist, 2 Comm. Fut. L. Rep. (CCH) ¶ 24,993 (C.F.T.C. 1991); *In re* Collins, [1986-1987 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 22,982, at 31,903 (C.F.T.C. 1986), *modified*, [1986-1987 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 23,401 (Nov. 26, 1986), *rev'd sub nom.* Stoller v. CFTC, 834 F.2d 262 (2d Cir. 1987).

deemed necessary to avoid large block trades having an undue effect on the market and to assure orderly execution of those orders.[170] In fact, there are over three thousand block trades per day on the NYSE, "accounting for more than 45 percent of the shares traded. Many of the blocks are of 250,000 shares."[171] In contrast, the CFTC and the commodity exchanges prohibit prior discussions about orders, even if the purpose of such discussions is to assure that there are sufficient buyers in the market to meet large orders.[172] This restriction causes severe problems, particularly in illiquid pits.

By approving a large order execution system, prices could be negotiated off the exchange among institutions. Traders could thereby set prices that more accurately reflect the value of the commodities being traded, rather than having these commodities dumped on a market that is unable to deal with them because of illiquidity or simply because of a lack of prior knowledge of the transaction. Presently, a proposal by the Chicago Mercantile Exchange is pending for a large order execution system,[173] and a New York bar committee has recommended that such systems be permitted for all exchanges.[174] The CFTC, however, long delayed action on these proposals[175] and the Chicago Board of Trade has opposed such a system.[176]

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170. *See* Committee on Futures Regulation of the Ass'n of the Bar of the City of New York, *Large Order Execution in the Futures Markets*, 44 Bus. Law. 1335, 1335 (1989) [hereinafter *Large Order Executions*].

171. Electronic Bulls and Bears, *supra* note 114, at 8. For a discussion of the growth of institutional trading on the New York Stock Exchange, see Poser, *Restructuring the Stock Markets: A Critical Look at the SEC's National Market System*, 56 N.Y.U. L. Rev. 883, 896-901 (1981).

172. *See supra* note 169.

173. *See* Markham, *supra* note 93, at 38-39.

174. *See Large Order Executions*, *supra* note 170.

175. As a result of the Stock Market Crash of 1987, the SEC suggested that procedures may be needed to handle large block trades in the stock index and futures markets. Oct. 1987 Market Break, *supra* note 112, at 3-18 n.49. The CFTC staff, however, asserted that this recommendation was simply a "pet theory" of the SEC and others. Andrea M. Corcoran, "Aftermath of the Crash: Policy Assessments, Public Perceptions and Prospective Reforms," Address at the Japanese Center for International Finance 11 (Mar. 1988). More recently, at the request of the Chicago Mercantile Exchange, the CFTC indicated some willingness to adopt a modified large order execution system by amending its rules to allow such systems if they meet the CFTC's approval. *Large Order Execution Procedures And The Crossing of Orders*, 2 Comm. Fut. L. Rep. (CCH) ¶ 25,019 (C.F.T.C. 1991). It subsequently approved such a system on the Chicago Mercantile Exchange. *Merc is Cleared to Trade Stock Index Futures Block*, Wall St. J., Oct. 1, 1991, at C16, col. 6. The CFTC staff has also suggested that, if dual trading is to be continued, "there are other mechanisms, such as the use of market makers, sunshine trading (a form of block trading), or large or small order trade execution procedures which might serve the liquidity functions which historically have been attributed to dual trading." Letter from Andrea M. Corcoran, Director of CFTC Division of Trading and Markets to Thomas R. Donovan, President, Mid-American Commodity Exchange (Mar. 8, 1989) at 3. But the CFTC may condition the use of large order execution systems on a requirement that such orders be disclosed to the trading pit and identified prior to

It seems inconceivable that large order transactions, which in the securities industry are deemed to be desirable and proper, should somehow become illegal when conducted in the commodity futures industry. This contrast underscores the fact that the Commodity Exchange Act may rightly be viewed as simply a protective measure for the commodity exchanges and their members, at whatever the cost to other market participants. In this context, the statute is simply being invoked to assure the monopoly advantages of locals. They are now assured that they will have the first shot at all orders—large and small—under the monopoly conditions that exist on the floors.

3. *Market Maker Obligations And Dual Trading*

The time and place advantage given to floor traders must also be examined. Commodity futures prices are highly volatile. Indeed, futures contracts on commodities are selected in large measure on the fact that their prices are volatile. The time and place advantage given to floor traders is critical to their competitive edge in that they can react to price changes more rapidly than traders located off the floor. Even with modern communication facilities, the time required to report what is happening in the pit from the floor and the time for that information to be assessed at an off-exchange location often presents a strong competitive disadvantage to those trading off the floor, particularly under chaotic conditions.

For a number of years the SEC considered whether floor traders should even be permitted on the securities exchanges and it has restricted their access.[177] However, eliminating or reducing the number of locals on com-

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execution. Letter to Thomas A. Russo from Andrea M. Corcoran, Director, CFTC Division of Trading and Markets, (Oct. 17, 1989). Customer consent may also be required. *Id.*

176. The Chicago Board of Trade recognizes that institutional traders are playing a much larger role in the futures markets. Early & Drizin, *CFTC/SEC Jurisdiction: 1990, Deja-Vu All Over Again, Memorandum Prepared for the FIA Law and Compliance Division Annual Workshop, Alexandria, Virginia* (May 3-4, 1990) at 22; *see also* Markham, *Federal Regulation of Margin In The Commodity Futures Industry—History and Theory*, 64 TEMP. L. REV. 59 (1991); White, *Wall Street Is Giving Big Clients Its Program Trading Firepower*, Wall St. J., May 1, 1991, at C1, col. 3; Angrist, *Virginia's Pension Fund Earmarks $100 Million for Futures Trading*, Wall St. J., Apr. 26, 1991, at C1, col. 4. However, the Chicago Board of Trade continues to oppose large order execution systems needed for institutional trading. *See* Letter from Thomas R. Donovan, President and Chief Executive Officer of the Chicago Board of Trade to Mrs. Jean A. Webb, Office of the Secretariat, CFTC (Jan. 4, 1990); *see also* Letter from Bennett J. Corn, President, Coffee, Sugar & Cocoa Exchange, Inc., to Ms. Jean A. Webb, Secretary, CFTC (Jan. 22, 1991). This may be because the number of "upstairs traders" has placed increased competitive pressure on the floor and has "made it tougher to make a living in the pit. Sometimes it can be 'hell on wheels.'" Kollar, *Melamed Remains a Vocal Force Despite Departure from the CME*, J. COM., Jan. 30, 1991; *see also* Markham, *supra* note 93, at 38. Nevertheless, large order execution problems persist. *See* Tanouye, *Comex Investigating Big July Silver Trade*, Wall St. J., Aug. 6, 1991, at C1, col. 3 (discussing difficulties with large order execution on commodity exchanges).

177. *See* 15 U.S.C. § 78k (1988); *Special Study*, supra note 141, at 5-7; SEC, REPORT OF THE FEASIBILITY AND ADVISABILITY OF THE COMPLETE SEGREGATION OF THE FUNCTION OF DEALER AND BROKER 109-114 (1936); 17 C.F.R. § 240.11a-1 (1991); V L. LOSS & J. SELIGMAN, *supra* note 127, at 2531-44; J. SELIGMAN, THE TRANSFORMATION OF WALL STREET 228-343 (1982).

modity exchanges might have the undesirable effect of impairing liquidity on the commodity exchanges because the locals supply trading volume for hedging and for executing customer orders. Nevertheless, corrective measures are needed to assure that this time and place advantage is not abused by the individuals now holding exchange franchises. In this regard, the Chicago Board Options Exchange, which utilizes an auction market modeled after the commodity exchanges, has imposed market maker obligations on floor traders on its floors. Similarly, specialists on other securities exchanges are required to have marketmaking obligations.[178] This means that such traders must buy or sell contra to market direction in order to reduce volatility. There are no such obligations in the commodity futures industry. If locals are to continue their time and place advantage, however, such restrictions should be imposed so that the public will be assured that the competitive advantage given to those traders is not abused.[179]

Another problem with floor traders and floor brokers faced by the CFTC is the fact that these persons may engage in both roles—*i.e.*, someone

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178. *See* REPORT OF THE SPECIAL STUDY OF THE OPTIONS MARKETS TO THE SEC 130-135 (Dec. 22, 1978); OCT. 1987 MARKET BREAK, *supra* note 112, at 4-1 to 4-3; 17 C.F.R. § 240.11b-1 (1991). Indeed, the SEC believes that marketmaking obligations are the very essence of an exchange. *See* Board of Trade v. SEC, 923 F.2d 1270 (7th Cir. 1991). These market maker obligations, however, have not eliminated the time and place advantage of specialists on the New York Stock Exchange. These specialists "unquestionably" have "access to valuable nonpublic information. Specialists can and do earn greater than average returns by exploiting this information regularly." Note, *The Efficient Capital Market Hypothesis, Economic Theory and the Regulation of the Securities Industry,* 29 STAN. L. REV. 1031, 1054 (1977). Marketmakers in the securities industry also did not perform well during the stock market crash of 1987. *See* Markham & Stephanz, *The Stock Market Crash of 1987—The United States Looks At New Recommendations*, 76 GEO. L.J. 1993 (1988).

For a discussion of the role of the specialist in the securities market, see generally V L. LOSS & J. SELIGMAN, *supra* note 127, at 2513-30. The SEC has proposed regulations that would impose further market making obligations on specialists by requiring them to enter "stabilizing" transactions where there is a sharp market break. Benham, *Deal Is Struck on Index-Futures Oversight*, Investors Daily, Oct. 18, 1990.

Recently Congress enacted legislation that authorizes the SEC to adopt rules to prohibit or contain during periods of extraordinary market volatility any trading practice which the SEC determines has previously contributed to market volatility and has threatened the maintenance of fair and orderly markets and is likely to do so in the future. *See Market Reform Act of 1990*, 104 Stat. 93 (1990).

179. The commodity exchanges have also begun to experiment with market making obligations. Markham, *supra* note 9, at 363. But the CFTC has stated that the Commodity Exchange Act "does not define the term 'market maker,' does not impose an affirmative obligation on floor traders to perform the role of market makers and does not regulate their activities as a separate class of traders." *In re* Buckwalter, 2 Comm. Fut. L. Rep. (CCH) ¶ 25,016 at 37,769 (C.F.T.C. 1991) (footnote omitted). However, to cite one recent example, the refusal by floor traders on the futures exchanges to assume any market making obligations proved to be troublesome during the recent war with Iraq in the Persian Gulf. *See* Taylor, *Oil Options Investors Irked by Trade Delays*, Wall St. J., Jan. 22, 1991, at C1, col. 3. Customers also continue to be subject to untoward "slippages" between market prices at the time of order entry and execution. *See* Angrist, *Futures Shock: Investors Cope With 'Slippage'*, Wall St. J., Apr. 30, 1991, at C1, col. 3.

can be both a floor trader and a floor broker on the same day. This often gives rise to claims of conflict of interest when traders are engaged in this so-called "dual" trading. Dual trading creates conflicts of interest when members trade both for their own account and for customers' and often leads to charges of fraud by the brokers. The CFTC is now considering whether to prohibit dual trading, particularly in light of the problems on the exchanges uncovered by the FBI sting operation in 1989. But it should be noted that the CFTC has been unsuccessfully wrestling with this problem for over 15 years. The CFTC has attempted to stop such dual trading for years and Congress has addressed the issue several times, but the exchanges have effectively blocked the elimination of this apparent conflict of interest. That reform should now be effected, at least in active trading pits, for no reason other than to bolster public confidence in these markets.[180]

Reforms of a more far reaching nature are also needed. For example, a reform needed to combat floor broker abuses is the adoption of a trading system in which customer orders are placed in a book for execution, preferably an automated book. Presently, the Chicago Board Options Exchange, which is regulated by the SEC, has a board broker system in which exchange employees hold customer limit orders in a so-called "book." Those orders are executed and given preference in the marketplace when their limits are reached.[181] The board broker system professionalizes order executions by reducing the need for "independent" floor brokers who often are so poorly capitalized they cannot sustain errors without cheating. Such a system would do much to eliminate the abuses exposed in the Chicago sting. The locals would not have the opportunity that now exists to prey on floor brokers. Instead, the board broker would be responsible to the whole trading pit and competing locals would seek to expose anyone being given preference in order executions. This system would better serve to keep both parties honest.

Another area of concern is that most large financial firms trade for their customers and for their own account or for those of their affiliates, particularly in the financial futures area. Traders on the so-called "proprietary" desk who are trading for the firm's or its affiliates' accounts may often be exposed to information concerning customer orders. This gives rise to conflicts of interest, as where market direction may be known because of a large influx of customer orders, allowing abuses such as front running to be engaged in by proprietary traders.[182]

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180. *See* Markham, *supra* note 93; *but see* Donohue, *Dual Trading in the Commodity Futures Markets: Should it be Banned?*, 21 Loy. U. Chi. L.J. 45 (1989) (suggesting increased regulation of dual trading, but not banning of practice).

181. Oct. 1987 Market Break, *supra* note 112, at 8-1 to 8-2. The specialist on the New York Stock Exchange also has an automated limit order book. *Id.* at 7-20. New technological changes may allow the New York Stock Exchange to reduce its staff, an action that is needed in order to reduce costs. *See* Torres, *Big Board Plans Wide-Scale Layoffs to Reduce Costs*, Wall St. J., Feb. 11, 1991, at C9, col. 5.

182. A former senior executive of one large brokerage firm has charged that he was fired

To prevent abuses by proprietary trades of brokerage firms, so-called "Chinese walls" should be erected between the proprietary trading and activities of customers. Such systems already exist in the securities and banking industry.[183] Chinese walls in the futures industry may not be simple or inexpensive. If proprietary trading is too small to sustain segregation, it can be routed through another brokerage firm. Other restrictions should be imposed upon upstairs activities. Some large brokerage firms have common order desks for particular exchanges where both proprietary trades and customer trades are routed to the floor. Proprietary traders may often be stationed around this desk, and the information they receive is invaluable as to market direction and what can be expected of the market, as where

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from the firm because he refused demands to divulge information to proprietary traders about the trading plans of futures customers. Potts & Lippman, *Is This Any Way to Set Oil Prices?*, Wash. Post, Jan. 12, 1991, at A1, col. 4; *see also Big Board Acts To Discipline Two Companies*, Wall St. J., May 31, 1991, at A9A, col. 3 (reporting that NYSE disciplined a broker and its employees, including a $1.3 million fine for altering program trade prices in favor of the firm and stating that it was unclear whether futures trading was involved, but that program trading is "often accompanied by simultaneous selling or buying of stock option or futures").

One exchange official has asserted that further regulations are needed to prevent individuals working "on a brokerage house order desk from taking an order and winking at his friend across the room, who takes the cue to place his own order ahead of the customer." Tanouye, *Coffee Exchange's New Chairman Faces Controversy in a Low-Profile Market*, Wall St. J., Apr. 1, 1991, at C6, col. 3; *see also* Sundel & Blake, *supra* note 163, at 775 (discussing "upstairs" trading abuses by brokerage firm employees having knowledge of customer orders). Trading ahead or "running ahead" of customer orders has long been a problem on the exchanges. *See Regulation of Commodity Exchanges, Hearing on H.R. 3009 (Commodity Exchange Act), Before the House Committee on Agriculture*, 74th Cong., 1st Sess. 29-30 (1935). It has also long been known that there is a conflict of interest where a broker is executing orders for customers and trading for the firm's own account. *Id.* at 25; *see also* United States v. Dial, 757 F.2d 163, 165, 168 (7th Cir.), *cert. denied*, 474 U.S. 838 (1985). A recent report suggests other concerns such as "loading the boat." This occurs where a brokerage firm holds customer orders and then enters them all at once to push up market prices— "traders can make money if they hop on for a cruise." Taylor, *Psst! Want to Make a Small Fortune in Futures Markets?*, Wall St. J., Aug. 30, 1991, at A1, col. 3.

The CFTC has adopted a regulation to prevent some abuses by brokerage firms, but it has not adopted a segregation of functions requirement. *See* 17 C.F.R. § 155.3 (1991). This regulation states that brokerage firms are to ensure to the extent possible that customer market orders are transmitted to the floor before proprietary orders. It does not, however, exclude proprietary traders for the brokerage firm from having access to the customer market orders or to limit orders. The latter are also invaluable in determining what may occur if a market responds in a particular direction because limit orders may accentuate price swings when limits are reached.

183. *See* Herzel & Colling, *The Chinese Wall and Conflict of Interest in Banks*, 34 BUS. LAW. 73 (1978); Poser, *Chinese Wall or Emperor's New Clothes? Regulating Conflicts of Interest of Securities Firms in the U.S. and the U.K.*, 9 MICH. Y.B. INT'L LEGAL STUD. 91 (1988). The need for a "Chinese Wall" in the futures industry was suggested long ago by regulatory authorities. *See* U.S.D.A., Commodity Exchange Authority, Administrative Determination No. 114 (May 21, 1941) (determining that trader of a firm "house account" would not violate Commodity Exchange Act by trading against customer orders if the trader did not have knowledge of the orders).

stop orders are backed up at a particular resistant point in the market. Here too, there should be a segregation of trading activities.

4. *A Curb Market is Needed*

The Chicago sting operation demonstrates a need for a curb market for after hours trading. A justification given by brokers for the after hours trading is that the closing moments on the exchange are often chaotic and it is impossible to execute customer orders in an orderly fashion. Therefore, it is necessary to continue trading after the closing bell. Otherwise customers will be denied fills and can be exposed to substantial risks if their orders are not filled. Floor traders believe that giving the customer a fill is critical to the customers and that the customers will accept fills even if the prices are not as competitive as they would otherwise be in a fair and orderly market during regular trading hours.[184]

Given the fact that there is an exchange monopoly, and that customers cannot execute their orders other than through a commodity exchange, curb markets do appear to be a needed feature of the exchanges. This is because there is no safety valve such as that found in the securities markets for over-the-counter or after hours trading in securities.[185] The CFTC, however, is now authorizing such curb markets and is setting the terms and conditions under which such trading is permitted. For example, the exchanges are authorized to have additional closing sessions during particularly tumultuous

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184. *See* Ashman Testimony, *supra* note 79, at 5388-89, 5449. Floor traders have also used after hours trading to even up their position—*i.e.*, a trader may not want to carry a position over night and will want to liquidate the position in the closing session. If that is not possible because of chaotic trading conditions, he will seek to trade with other traders after the close of trading in order to make himself "flat," thereby avoiding an over night exposure. This has long been a practice in the futures industry. 5 REPORT ON THE GRAIN TRADE, *supra* note 10, at 147.

185. Some commodity futures exchanges have extended their trading hours to allow evening sessions. *See War Means No Sleep for CBOT Traders*, Wall St. J., Jan. 29, 1991, at C1, col. 3; Herman & Torres, *Up All Night Watching the War? Got An Urge to Trade?*, Wall St. J., Jan. 22, 1991, at C1, col. 3. In addition, linkages have been developed with foreign exchanges to allow extended trading hours, although these have not been particularly successful. *See* Markham & Bergin, *The Role of the Commodity Futures Trading Commission in International Commodity Transactions*, 18 GEO. WASH. J. INT'L L. & ECON. 581, 596-598 (1985); Wolman, *Singapore 5; From A Slow Start to Soaring Trading Volumes*, Fin. Times, Nov. 13, 1987, at V; *Exchanges Continue to Forge Trading Links Despite Slow Volume To Date*, SEC. WK., July 6, 1987, at 1.

A phenomenon known as EFPs (exchange of futures for physicals) has also been utilized to extend trading hours. Simply stated, these transactions involve a swap of a physical or a forward contract for a futures contract. Exchanges in London trade in forward contracts and these have been swapped for futures contracts outside normal trading hours of the U.S. exchanges. *See generally* CFTC DIVISION OF TRADING AND MARKETS, REPORT ON EXCHANGES OF FUTURES FOR PHYSICALS (Oct. 1, 1987); Seifert, *Exchanges of Futures for Physicals Transactions: A Regulatory Exception and Means for Off-Price Exchange Use of Exchange-Traded Instruments*, Futures Industry Association, L. & Compliance Div. Annual Workshop, Annapolis, Md. (May 20-21, 1986); *Large Order Executions*, *supra* note 170.

markets. This, of course, should not be administered in a way that will result in extended trading hours that create a need for even further extended after hours trading.[186]

Principally in response to foreign competition, the exchanges have been developing automated systems that would allow after hours trading. For example, the Globex system is designed to allow computerized order entry for after hours trading. Globex essentially seeks to extend trading to a twenty-four hour a day basis. This would do much to alleviate the need for curb trading, although a curb session may be necessary to complete order overflows in busy closing sessions on the floor of the exchange itself. The Globex system should also provide an audit trail that should allow better surveillance of after hours executions.[187]

5. *Specific Trading Prohibitions Are Needed*

Another shortcoming in the Commodity Exchange Act is that its prohibitions against fraud, manipulation and abusive trading practices are often vague and undefined. The Commodity Exchange Act is further limited by the fact that the CFTC has not adopted rules prohibiting particular fraudulent or abusive practices (whether from deference to the industry or because it views its rulemaking authority to be too narrow is uncertain). The most dramatic example of this shortcoming is the fact that, while a central focus of the Commodity Exchange Act is to prohibit manipulation, the term "manipulation" is not defined anywhere in the statute. In addition, the Act does not give the CFTC authority to define that provision. The result has been a piecemeal approach to defining and prohibiting manipulation that

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186. For example, the curb market session would be signaled by a bell in the trading ring. At that time, no further orders could be accepted at any trading desk. Only orders already on the floor could be transmitted to the pit for execution. The after hour session should be brief—as little as three minutes should be sufficient to allow a cleanup of existing orders. The CFTC has approved rules of this nature, which also allow exchange members to even up their positions after the close of trading. Rosenbaum, *Contested Trades: Hot Potato or Hot Air?*, FUTURES MAG., Jan. 1991.

187. *See Gunning for Globex*, FUTURES AND OPTIONS WORLD, Nov. 1990, at 30; CHICAGO MERCANTILE EXCHANGE, GLOBEX (1989); Berg, *2 Big Futures Exchanges in a Race*, N.Y. Times, Apr. 11, 1989, at D2, col. 1. The Globex system is an automated trading system, but it would be open only for after hours trading. Globex is so limited in scope because the exchanges continue to resist "bringing technology into their domestic trading pits during the normal trading day." ELECTRONIC BULLS AND BEARS, *supra* note 111, at 5; *see also* Kollar, *Melamed Remains a Vocal Force Despite Departure from the CME*, J. Com., Jan. 30, 1991 (stating that Globex was designed so that it would not reduce the income of the traders on the floors of the exchanges). Nevertheless, the Globex system may siphon off a substantial number of orders out of the commodity futures pits. *See* McMurray, *Riding High: Tom Baldwin's Trades in Chicago T-Bond Pit Can Move the Market*, Wall St. J., Feb. 4, 1991, at C1, col. 1; *see also* Durr, *Globex "On Target for Launch Early Next Year"*, Fin. Times, Nov. 6, 1990; *New York Merc Advances After-Hours Trading Plan*, Wall St. J., at A14, col. 4 (discussing efforts by one New York exchange to establish after hours trading network).

has led to an almost complete evisceration of this purpose of the statute.[188]

But the failure to exercise rulemaking authority is not a problem that is limited simply to manipulation. That shortcoming pervades much of the Commodity Exchange Act. For example, the government has often been stymied in policing and preventing abusive trading practices because it has not promulgated rules that attack particular fraudulent or abusive trading practices.[189] This failure stands in stark contrast to actions taken by the SEC pursuant to the federal securities laws. The SEC has been given broad authority to promulgate rules that attack specific practices. The SEC has used this authority to adopt strong regulatory programs.[190] The results are dramatic. For example, while the CFTC has only brought some 15 manipulation cases in its entire history, the SEC brings nearly that number of cases each year.[191]

This gap in the Commodity Exchange Act actually fosters trading practices that are fraudulent or abusive. The so-called "leads," "edges," and "matches" that were exposed by the Chicago sting operation are not specifically prohibited by the Commodity Exchange Act, even though they seem to have been present in the markets for many years. The Commodity Exchange Act does prohibit "accommodation" trades, "cross" trades, "wash" sales or "fictitious" trades, but those terms are not defined in the statute and are of uncertain scope.[192] For example, there is confusion as to exactly what constitutes an "accommodation" trade. A federal study conducted in 1921 suggested that accommodation trades were simply transfers of positions between brokerage houses so that margin requirements could be reduced.[193] Such transactions were innocuous and far removed from the

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188. *See* Markham, *supra* note 9. Another gap in the Commodity Exchange Act that fosters disruptive trading and manipulation is the fact that there is no effective regulation of large scale trading by commercial firms. *Id.* at 367-71; *see also* Kanabayashi & Behrmenn, *Sunitomo's Hamanaka Inspires Anger and Respect In Pit*, Wall St. J., May 29, 1991, at C1, col. 3.

189. The reason for the failure to adopt such rules is unclear. It may be due to the ideological bent of the CFTC whose individual Commissioners have generally been economists that oppose regulation in almost any form. Moreover, there is no specific provision in the Commodity Exchange Act that provides for rulemaking authority to prohibit manipulation or specific fraudulent conduct. Although there is an overall broad provision that authorizes the Commission to adopt such rules as are necessary to carry out the purposes of the statute, the CFTC has not placed much reliance on that provision. *See* 7 U.S.C. § 12a(5) (1988); *see also* *supra* note 31 (discussing scope of this provision).

190. *See supra* note 30.

191. *See* Markham, *supra* note 9, at 361-62. Of course, the SEC has a larger staff and its focus on the manipulation of the stock of a particular company is more narrow than a broad based commodity manipulation that is often faced by the CFTC. But those shortcomings would actually argue in favor of the CFTC being given more pointed authority so that it could husband its resources and so that it would not have to address the economics of a broad market manipulation. Instead, it could attack specific manipulative practices more effectively. *See id.*

192. *See* 7 U.S.C. § 6c (1988).

193. *See* 5 REPORT ON THE GRAIN TRADE, *supra* note 10, at 251-52.

trading practices that were the subject of the sting operations in Chicago. Similarly, the term "cross" trade is not defined in the Commodity Exchange Act. In the debates on the statute in 1936, however, cross trades were defined as transactions that approximate "matched" trades—*i.e.*, cross trades are devices "commonly employed by pit brokers who are becoming buyers in respect to selling orders of customers and vice versa."[194] This term, however, was the subject of much debate because there was concern that prohibiting cross trades could suppress legitimate transactions, such as where a broker was executing buy and sell orders for different customers competitively in the market place.[195] The prohibition against "fictitious" trades is equally uncertain in scope. Indeed, in *United States v. LaMantia*,[196] a district court held that this term was so vague as to be unconstitutional.[197] Seeking to clear up that vagueness, the CFTC later stated that a fictitious sale would include prearranged trading in which trade information such as price and quantity were determined outside the trading pit, "then using the market mechanism to shield the private nature of the bargaining from public scrutiny, both price competition and market risk are eliminated.[198] But this formula is unintelligible and offers little or no guidance as to what is permitted under the Commodity Exchange Act.

The government has also encountered difficulties in determining what a prohibited "wash" sale is under the Commodity Exchange Act. In *Stoller v. CFTC*,[199] the Second Circuit found that the CFTC had taken conflicting positions on what constituted a wash trade and it, therefore, dismissed a CFTC action charging that a trader had engaged in wash trading when he made simultaneous purchase and sale transactions. More recently, the CFTC has conducted investigations and brought charges against various Japanese trading houses that have engaged in simultaneous buy and sell transactions for Japanese tax purposes.[200] In one such case, an ALJ dismissed the CFTC's charges of wash trading because the CFTC did not show that there was an improper purpose to the trades in question.[201] The Chicago Board

194. 80 Cong. Rec. 8088-90 (1936).

195. *See* 80 Cong. Rec. 7871, 7905-06 (1936).

196. [1977-1980 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 20,667 (N.D. Ill. 1978).

197. *Id.* The court in *LaMantia* noted that the term "fictitious" sale was not defined in the Commodity Exchange Act; that even though the Commodity Exchange Act had been in existence for over forty years, there had been no judicial construction of that term; and that treatises on commodity trading did not use the term "fictitious" sale. *Id.*

198. *In re* Collins, [1986-1987 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 22,982 (C.F.T.C. 1986), *rev'd on other grounds sub nom.* Stoller v. CFTC, 834 F.2d 262 (2d Cir. 1987).

199. 834 F.2d 762 (2d Cir. 1987).

200. *See CFTC Settles with Balfour Maclaine, Tokyo Broker, Ex-Officers*, Sec. Wk., Apr. 23, 1990, at 6; CFTC News Release No. 3238-90 (April 18, 1990).

201. *In re* Three Eight Corp., 2 Comm. Fut. L. Rep. (CCH) ¶ 24,944 (C.F.T.C. 1990). *Compare In re* Angelo, 2 Comm. Fut. L. Rep. (CCH) ¶ 24,943 (C.F.T.C. 1990) (holding that so-called "ginzy" trades used to shift funds from one account to another had not been shown to be prearranged or non-competitive) *with In re* Murphy, [1984-1986 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 22,798 (C.F.T.C. 1985) (holding so-called "ginzy" trades to be violative of the Commodity Exchange Act).

of Trade has also taken issue with a CFTC staff assertion that floor brokers on the exchanges are responsible for knowing the purpose of traders entering simultaneous buy and sell transactions.[202]

The confusion surrounding what constitutes a wash sale seems incredible. This is perhaps the most basic market abuse and has long been dealt with in the securities markets.[203] Such trades are certainly no stranger to the futures markets, having been attacked for many years by the Commodity Exchange Authority.[204] The CFTC, however, has in a recent series of cases made the situation much worse and made punishment of wash sales and abuses such as those uncovered by the Chicago sting operation even more difficult to prove and prevent.

These cases arose from early efforts by the CFTC to attack fraudulent trading practices that were being used to avoid and evade taxes during the 1970s. The CFTC brought several cases charging that so-called "tax spreads" were being executed by wash trades or pre-arranged and fictitious trades so as to assure tax losses.[205] Grand juries were empaneled in New York and Chicago to attack these practices and several convictions resulted.[206] Those criminal cases, however, apparently had little lingering deterrent effect as evidenced by the Chicago sting operation. In addition, the CFTC delayed final action on many of the tax related cases it brought. Indeed, it did not render a decision on some of them for ten or more years after the events at issue. Unfortunately, aside from the weakened deterrent effect of such delays, these decisions do little to elucidate exactly what trading practices are prohibited under the Commodity Exchange Act. They speak in broad generalities and turn on individual issues of proof. In each case the CFTC found a failure of proof. Indeed, the CFTC's case-by-case approach actually appears to be a step backward.

For example, in In re *Allen J. Rosenberg*, the CFTC dismissed charges against a respondent because, while the trading was suspicious, the CFTC Division of Enforcement could not tell whether apparent "money pass"

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202. *See* Chicago Board of Trade, Monthly Letter to Members, Jan. 1990, at 1-2.

203. *See, e.g.*, 15 U.S.C. § 78i(a)(1) (1988); Goddard v. United States, 86 F.2d 884 (10th Cir. 1936); Harris v. United States, 48 F.2d 771 (9th Cir. 1931); United States v. Brown, 5 F. Supp. 81, 85 (S.D.N.Y. 1933), *aff'd*, 79 F.2d 321 (2d Cir. 1935), *cert. denied sub nom.* McCarthy v. United States, 296 U.S. 650 (1936); *but see* Wright v. SEC, 112 F.2d 89, 93-94 (2d Cir. 1940).

204. *See In re* Goldwurm, 7 Agric. Dec. 265 (1948); *In re* Thomas Jordan & Co., 7 Agric. Dec. 381 (1948); *see also* CFTC v. Savage, 611 F.2d 270 (9th Cir. 1979) (discussing abusive trading practices attacked by Commodity Exchange Authority).

205. *See* 13 J. MARKHAM, *supra* note 169, at § 14.01.

206. *See* Laing, *U.S. Study of Soybean Trading Is Seen Leading to Tax Law, Other Indictments*, Wall St. J., Aug. 9, 1976, at 18, col. 2; United States v. Turkish, 623 F.2d 769 (2d Cir. 1980), *cert. denied*, 449 U.S. 1007 (1981); Sundheimer v. CFTC, 688 F.2d 150 (2d Cir. 1982), *cert. denied*, 460 U.S. 1022 (1983); United States v. LaMantia, [1977-1980 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 20,667 (N.D. Ill. 1978). For a more complete listing of these criminal cases, see American Bar Association, Section of Litigation, CRIME IN THE PITS: AN ANALYSIS OF THE INVESTIGATION AT THE CHICAGO COMMODITIES MARKETS Tab. 3 (1990).

transactions were gifts, kickbacks, rebates, or whatever.[207] There, the trader claimed that he was actually a "marketmaker" who had to take the risks of losing positions in order to protect his overall financial position.[208] The CFTC found that this justification for the unusual trading patterns at issue precluded the Division of Enforcement from establishing its case, at least in the absence of proof showing that the trading was for some improper purpose.[209] But this approach underscores the need for more adequate regulation. The enforcement staff simply cannot reach into the minds of traders or penetrate a conspiracy without undergoing an elaborate sting operation such as that seen in Chicago.

In another of these cases, In re *Buckwalter*, which was decided some thirteen years after the events in question, the CFTC noted that the conduct at issue established a pattern of trading that created an inference of arrangement for non-competitive execution of futures contracts.[210] The CFTC found that the respondents had engaged in a series of trades that realized a loss at a convenient time, with both realizing a comparable gain at later convenient time. The CFTC, therefore, found a pattern of suspicious conduct in the trading at issue. It stated, however, that such suspicious conduct may not be enough to prove a violation unless such conduct is coupled with a motive. Here, there was motivation because of tax benefits. But there was a failure of proof as to some aspects of the case because it was not shown by a preponderance of the evidence that two individuals had engaged in violative trading. Certain payments which respondents claimed to be disguised payments to one respondent were not proven to be violative even though the trading was "certainly suspicious" and involved the passing of trading profits to an account that a respondent controlled under a false name.[211] The CFTC also found implausible that two respondents would engage in an arrangement for noncompetitive executions that created losses for them and gains for the respondent.[212] This seems almost naive since the Chicago sting operation exposed the fact that transfers of money were often done through trading in the pits.[213]

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207. 2 Comm. Fut. L. Rep. (CCH) ¶ 24,992 (C.F.T.C. 1991).

208. *Id.* at 37,642.

209. *Id.* at 37,644.

210. 2 Comm. Fut. L. Rep. (CCH) ¶ 24,995 (C.F.T.C. 1991).

211. *Id.* at 37,685.

212. *Id.* at 37,685-86.

213. *See* Proposed Rule Concerning Restriction on Dual Trading by Floor Brokers, 55 Fed. Reg. 1047 (Jan. 11, 1990) (discussing money pass transactions in sting operation). More recently, the CFTC's Division of Enforcement has asserted that:

> Commission case law also establishes that wash sales occur when traders, through non-competitive executions, arrange to pass money to each other. In In re *Gimbel*, ¶ 24,213 at 35,004, the Commission, citing In re *Robert E. O'Grady*, 30 A.D. 1635 (1971), reaffirmed that money pass transactions violate the wash sale provision of section 3c(a)(A) of the Act.

Division of Enforcement's Pre-Hearing Memorandum, *In re* Bell, CFTC Doc. No. 90-29 at 27 (C.F.T.C. Mar. 11, 1991).

In In re *Bear Stearns*, another of the long delayed CFTC decisions, the CFTC found that the record did not support charges against two respondents and the case against them was reversed.[214] Once again, the CFTC gave little guidance as to what is permitted or prohibited and how these cases can be proved. Indeed, the burden of proof established by the CFTC was almost unsurmountable, as perhaps demonstrated by the fact that this case took some fourteen years to be resolved by the CFTC.

In still another long delayed decision, In re *Gilchrist*, the CFTC again considered non-competitive trading claims that were apparently based upon tax trading.[215] Charges against certain respondents were also reversed in that case. The CFTC found itself stymied in this case because it was not clear what the respondents' motivation was when they entered into the trades in question. The CFTC stated that a respondent's mere participation in trades that are consistent with one or more arrangements for noncompetitive transactions was not a reliable basis for inferring that he knowingly participated in noncompetitive trades.[216] One respondent was held liable because he had segregated the trades in question in a separate account. Other traders had not done this and it was unclear as to their motivation. Charges against them were dismissed.

Among other things, the CFTC also reversed a finding in *Gilchrest* that a respondent engaged in a wash sale. The CFTC stated that generally in considering whether a prohibited wash sale has occurred it will look for a (1) purchase and sale (2) of the same delivery month of the same futures contract (3) at the same (or a similar) price.[217] Here, however, the nullity that was obtained was not the result of a transaction in the same futures contract. Rather, losses were offset in futures contracts different from those in which gains had been obtained. Nevertheless, the CFTC found that other trading by certain respondents was noncompetitive. In reference to those trades, the CFTC stated that the prices could be deemed to be "true" in some limited sense but this could not be deemed bona fide for purposes of the Commodity Exchange Act.[218] The CFTC stated that, even where a prearranged trade is executed in the pit, such a transaction will be deemed to be fictitious because, while the execution appears to be the result of open outcry, the prearrangement of the trade negates risk and price competition.[219] It is unclear what this means.

The result of all these decisions is to place an almost impossible burden on anyone seeking to prove that abusive trading practices violate the Commodity Exchange Act. It appears that the CFTC will require direct proof that challenged transactions are done in a noncompetitive manner. This would require a matched result or a series of transactions that are

214. 2 Comm. Fut. L. Rep. (CCH) ¶ 24,994 (C.F.T.C. 1991).
215. 2 Comm. Fut. L. Rep. (CCH) ¶ 24,993 (C.F.T.C. 1991).
216. *Id.* at 37,651.
217. *Id.* at 37,653.
218. *Id.*
219. *Id.* at 37,653, n.26.

unlikely to have occurred in the absence of prearrangement. Upon such proof, the trades may be deemed "suspicious," but something more is required to prove a violation. It would seem that the CFTC requires some strong proof of motivation for engaging in noncompetitive transactions, or some other form of proof to show that there is something more than mere suspicious activity. The CFTC seeks to do this in order not to restrict "legitimate" activity. The result, however, is effectively to foster abusive trading because it is particularly difficult to establish suspicious trading patterns when, as was seen in the Chicago sting operation, traders interject third parties to "scratch" trades in order to cover up the fact that they were given to other traders as matches or leads. To try to establish noncompetitive activity in a liquid market where patterns of suspicious activity are much more difficult to isolate may well be impossible. When a requirement of establishing motive is coupled with the foregoing obstacles, prosecution becomes problematic. These cases, therefore, constitute a severe setback for effective regulation and may undercut everything that may have been accomplished by the Chicago sting operation.

What is needed are rules specifically describing what transactions are prohibited. Such rules can be applied precisely and promptly to violative activity. The difficulty with formulating rules by adjudicatory decision, such as the CFTC sought to do in the above cases, is that such rules tend to be stated in broad generalities. This is because of the CFTC's concern that, if its prohibitions are too precise in their definition, legitimate transactions may be impaired. That concern can be avoided by rules. Rules can be specific in their prohibitions and legitimate practices can be pointed out by commentators and exempted. Conversely, unique or ingenious fraud schemes can be addressed in the context of the broader prohibitions of the statute, or even a blanket fraud provision.

The CFTC should be given authority to adopt rules that would define and prohibit specific fraudulent and manipulative trading practices. A good start for such rules would be simply to take the testimony elicited in the Chicago sting operations and adopt rules that would attack those specific practices. Other rules would prohibit such fraudulent trading practices as "frontrunning," where a trader with advance knowledge of an order that would have market effect trades in advance of that order.[220] Manipulative trading practices should be banned and insider trading prohibition should be considered.[221]

220. For examples of such rules, see Markham, *supra* note 93, at 48-51. Efforts are also being made in the securities industry to impose regulations that seek to prevent front running abuses. *See* Salwen, *House Approves Measure Giving SEC Power to Act Against Program Trading*, Wall St. J., Oct. 1, 1990, at C10, col. 5. Even advocates of greed in the markets would seem to be in favor of rules that prevent the defrauding of customers by shuffling losses to the public and keeping profits for floor traders. *See* Ibaszak, *Federal Judge Makes the Case for Greed In The Markets*, Chi. Sun-Times, Nov. 16, 1990.

221. The CFTC previously rejected the concept of insider trading under the Commodity Exchange Act except for government or exchange officials. CFTC, A STUDY OF THE NATURE,

IV. Conclusion

The franchise given to exchange members denies access to the floor to all but a limited group of individuals who must recover the high cost of their franchise and maintain profitability in an extremely volatile environment. Traders on the floor of the exchanges who trade for their own accounts must make profits consistently in order to survive. This places a strong incentive on these floor traders or "locals" to preserve and to utilize fully the monopolistic time and place advantages they enjoy on the floor. That time and place advantage gives them a decided competitive advantage over other traders. Unfortunately, even that competitive advantage is frequently viewed to be insufficient and fraudulent or abusive practices are engaged in by floor members. Those practices are difficult to detect and prosecute because of the shroud of secrecy that envelopes the club-like atmosphere of the floors.

Floor brokers who execute customer orders under their monopoly franchise also benefit from the absence of competition. These "independent" floor brokers are supposed to represent the interests of the brokerage firm customers on whose behalf they are executing orders. They are supposed

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Extent and Effects of Futures Trading By Persons Possessing Material, NonPublic Information, Submitted to the Committee on Agriculture of the House of Representatives and the Committee on Agriculture, Nutrition And Forestry of the Senate Pursuant to Section 23(b) of the Commodity Exchange Act, as Amended (Sept. 1984). Recently, however, a surge of trading activity took place in the coffee futures market just before Brazil halted its coffee exports. This again raised the question of whether insider trading prohibitions in the futures markets are needed. *See* Bruce, *Brazilian Committee to Probe Alleged Coffee Insider Trading*, J. Com., Mar. 27, 1991; Tanouye, Powers & Salwen, *Insider Trading on the Coffee Exchange? It's No Crime*, Wall St. J., Apr. 29, 1991, at C16, col. 4; Tanouye & Michaels, *U.S. Regulators Probe a Surge in Coffee Trades*, Wall St. J., Mar. 25, 1991, at Cl, col. 6; *see also* United States v. Dial, 757 F.2d 163, 165, 168 (7th Cir.), *cert. denied*, 474 U.S. 838 (1985); Lambert & Semel, *CEF Firms, Traders Indicted on Fraud Charges*, Wall St. J., June 5, 1991, at C20, col. 3 (reporting that traders were indicted for trading in advance of customer orders, which allegedly allowed defendants to profit from price increased caused by customer orders).

The CFTC has conceded that noncompetitive trading "undermines the public's confidence in the futures markets by contributing to the suspicion that insiders are controlling the market for their own benefit." *In re* Gilchrist, 2 Comm. Fut. L. Rep. (CCH) ¶ 25,024 at 37,805-6 (C.F.T.C. 1991). Nevertheless, it is fighting proposals to prohibit insider trading in the futures industry. *See* Salwen, *Lone Wolf at CFTC Bares Teeth*, Wall St. J., Mar. 27, 1991, at Cl, col. 3 (reporting that "deep-pocketed futures industry" is joining with CFTC in fighting efforts to include insider trading prohibition in Commodity Exchange Act). The House of Representatives, however, has approved a bill that would, among other things, prohibit individuals from using nonpublic information regarding their firm's commodity transactions to profit for their own accounts. *See* H.R. Rep. No. 102-6, 101st Cong., 2d Sess. 41 (1991).

For an example of rules that would prohibit abusive "insider" practices, see Markham, *"Front-Running"—Insider Trading Under the Commodity Exchange Act*, 38 Cath. U.L. Rev. 69, 124 (1988). *See also* Note, *Trading in Commodity Futures Using Nonpublic Information*, 73 Geo. L.J. 127 (1984); *but see* Booth, *Insider Trading, Better Markets*, Wall St. J., June 28, 1991, at A12, col. 4 (contending that insider trading on futures exchanges justifies legalizing use of insider information on securities markets).

to do this by obtaining the best possible price in the pit. The Chicago sting operation suggests that, in fact, many floor brokers are more concerned with simply obtaining executions at any price so that they can earn their commissions without liability for errors. Moreover, to avoid liability for errors, mistakes are often covered up or paid back by cheating customers.

These practices are fostered by Section 4 of the Commodity Exchange Act, which establishes a monopoly position for the exchanges in the trading of commodity futures contracts. The exchanges limit the number of their members, thereby limiting access to the floors of the exchanges. The value of this monopoly right is reflected in the high cost of exchange memberships. The economic costs of this monopoly are also reflected in the noncompetitive practices exposed by the Chicago sting operation.

Reform is needed in the regulation of commodity futures contracts. Section 4 of the Commodity Exchange Act should be eliminated and the provisions of the Act which give the CFTC exclusive jurisdiction over futures contracts should be either softened or eliminated. By effecting these changes, the commodity futures markets will become more competitive. The changes will also allow the development of off-exchange instruments to proceed unimpaired, provided there is effective alternative regulation such as that found in the federal securities laws. Competition from the securities exchanges would help assure that the trading practices uncovered by the Chicago sting operation are not carried forward in the future. These changes will also eliminate the "franchise" of exchange members who now have a statutory monopoly that gives them a time and place advantage over all other traders without any commensurate market obligations.

In addition, the Commodity Exchange Act should be amended to require that the Board of Governors of the commodity exchanges be composed of a majority of individuals who represent the public and who are not associated with exchange members. The Act should also mandate, to the extent possible, that exchanges make membership available to everyone who meets minimum financial requirements and standards of integrity.

Exchange trading mechanisms must also be updated. As demonstrated by the Chicago sting operation there is a strong need for an automated small order execution system. In addition, large order executions such as those used on the securities exchanges should be introduced to the commodity futures industry to provide alternate mechanisms for the execution of large orders. A curb market needs to be created and as many aspects of the trade as possible should be automated. Further, traders on the floors of the commodity exchanges should be required to assume market maker obligations, and there should be an automated limit order book maintained by an independent entity—*i.e.*, someone who is not associated with the floor brokers and floor traders in the pit.

Congress should further amend the Commodity Exchange Act to provide the CFTC with statutory authority to adopt regulations defining particular fraudulent practices. These regulations should be specific in their content and directed at identified practices, such as those uncovered by the Chicago sting operation. By imposing such specificity, prosecutions can be conducted

more effectively and traders will be advised specifically of what conduct is permitted or prohibited.

These proposals would represent dramatic changes in the commodity futures industry. This industry has flourished for some 125 years and it has been one of the most innovative areas of the financial services industry. It has also experienced phenomenal growth in recent years.[222] That phenomenal growth, however, has brought the importance of the commodity futures industry to a new level in our commerce. Today, a broad number of persons are involved in or are affected by the commodity futures market in some way. The significance of these markets now makes it imperative that they be regulated in an effective manner. The Chicago sting operations have disclosed that effective regulation is not existent today. The proposals described above, however, would bring the commodity exchanges to a regulatory level comparable to that in the securities industry. Without these changes, one can safely predict that the conduct exposed by the Chicago sting operation will continue on the exchange floors, particularly as the memory of those prosecutions dim.

222. Manipulation continues to be a problem in the futures industry. *See* Markham, *supra* note 9 (containing general discussion of manipulation); Taylor, *U.S. Looks Into Claim of 'Leak' of Market-Moving Weather Data*, Wall St. J., July 16, 1991, at C1, col. 4 (discussing possible price manipulation from weather service leaks); Taylor & Kilman, *In CBOT's Grain Pits, July Can Be the Cruelest Month*, Wall St. J., July 18, 1991, at C1, col. 3 (discussing prior manipulations).