Washington and Lee Law Review

Volume 38 | Issue 3 Article 4

Summer 6-1-1981

An Introduction to the Rules and Regulations Governing National Banks and Their Use of Financial Futures

Jack A. Barbanel

Follow this and additional works at: https://scholarlycommons.law.wlu.edu/wlulr

Part of the Banking and Finance Law Commons, and the Securities Law Commons

Recommended Citation
Jack A. Barbanel, *An Introduction to the Rules and Regulations Governing National Banks and Their Use of Financial Futures*, 38 Wash. & Lee L. Rev. 813 (1981).
Available at: https://scholarlycommons.law.wlu.edu/wlulr/vol38/iss3/4

This Article is brought to you for free and open access by the Washington and Lee Law Review at Washington and Lee University School of Law Scholarly Commons. It has been accepted for inclusion in Washington and Lee Law Review by an authorized editor of Washington and Lee University School of Law Scholarly Commons. For more information, please contact christensena@wlu.edu.

AN INTRODUCTION TO THE RULES AND REGULATIONS GOVERNING NATIONAL BANKS AND THEIR USE OF FINANCIAL FUTURES

JACK A. BARBANEL*

Trading in financial futures contracts is now the fastest growing area of commodities transactions.[1] This growth is illustrated by the geometrically expanding annual volume of trades on the Chicago Board of Trade ("CBOT"), an originator of and leading exchange for financial futures contracts. Since the start of trading in 1975 the volume of transactions has doubled each year with over 7 million contract transactions taking place on the CBOT in 1980 alone.[2] At the same time that there has been such unparalleled growth in the use of financial futures contracts as an investment tool, there has been an increasing awareness of the dangers posed to the continued growth and vitality of this market by the potential for trading abuses and the lack of understanding of the regulatory framework. Already, abuses in the trading of forward contracts for delayed delivery of Government National Mortgage Association ("GNMA") securities[3] have lead to demands for increased regulation

* Vice President and General Counsel, Commodities Corporation, Princeton, N.J.; B.A. 1972, University of Maryland; J.D. 1975, Delaware Law School; L.L.M. (Corporation) 1979, New York University. The author gratefully acknowledges the research assistance of Daniel Goldschmidt, J.D., 1981, New York University.

[1] *See* CHICAGO BOARD OF TRADE, MARKET GROWTH, INTEREST RATE FUTURES NEWSLETTER 1 (June 25, 1980). On the CBOT, trading volume for May 1980 was up 148% from May 1979 levels. *Id.* The Wall Street Journal lists transactions in numerous financial futures on a daily basis. The financial futures contracts covered by the Wall Street Journal are contracts for British pounds, Japanese yen, Swiss francs, West German marks, Government National Mortgage Association ("GNMA") securities, Treasury Bonds, and Treasury Bills. Other widely traded financial futures are commercial paper, certificates of deposit, and Treasury Notes.

[2] The 7 million contract transactions figure does not include financial futures contracts traded on the other Chicago and New York exchanges.

[3] GNMA securities are shares in a pooled group of government-insured mortgages. GNMA guarantees the monthly payments of principal and interest by the mortgagors in the group to the group's shareholders. *See* notes 29-31 *infra*, and accompanying text.

GNMA was created in 1968 when the Federal National Mortgage Association (FNMA) was rechartered. The GNMA's primary purpose is to aid the housing market in times of "tight money" by buying up FNMA mortgages and by guaranteeing the mortgage-backed securities issued under the plan described in notes 29 and 31 *infra*. *See* 24 C.F.R. §§ 300.3, 300.5 (1981). Pursuant to Title III of the National Housing Act, 12 U.S.C. §§ 1716-1723 (1976), Congress structured the GNMA to attract individual investors and other previously untapped sources of investment to the mortgage market, with the purpose of both increasing the supply of affordable housing for middle-income families and assuring the availability of home mortgages for all properties and to all potential home buyers. Bar-Levav, *Trading Abuses in Ginnie Maes: The Need for Regulation*, 8 SEC. REG. L.J. 42, 43-44 (1980) [hereinafter cited as Bar-Levav].

of financial futures trading.[4]

In December 1976, the First Federal Savings and Loan Association of Jasper, Alabama, reported to the Securities and Exchange Commission that First Federal had received from its securities dealer written confirmation of forward transactions that First Federal had never authorized. The terms of the trades obligated the small savings and loan, which had an investment portfolio amounting to $5 million, to take delivery of $7 million worth of GNMA securities.[5] Commodities trading has long been subject to abuses perpetrated by high-pressure salesmen in search of quick profits who are not reluctant to engage in questionable practices.[6] The involvement of a bank, especially a federally chartered bank, added a new and troubling element to a familiar scenario.

The possibility of bank involvement as the victim of classic quick profit schemes adapted to the financial futures market was one concern that prompted initial efforts by the federal banking agencies to set permissible guidelines within which a bank may trade financial futures. A second major concern of the regulatory agencies was the banking industry's ability to handle this very specialized area of financial activity. Thus, the installation of self-protective mechanisms was a primary concern in considering various guidelines that would permit national banks to enter the financial futures arena. This article will review past regulatory efforts in the area of bank investment in financial futures and set out the current regulatory framework.

The Statutory Background of Banking and Financial Futures

Prior to the Commodity Futures Trading Commission Act of 1974, ("CFTC Act"),[7] a commodity was defined by the Commodity Exchange Act[8] as one of a specific group of listed agricultural products.[9] The CFTC Act changed the definition of "commodity" to include "all other goods

---

[4] *See* Bar-Levav, *supra* note 3. In that article the author discusses the current movement to regulate the Ginnie Mae market and concludes that at the very minimum what is needed is industry self-regulation via an organization set up by Ginnie Mae securities dealers. Alternatively, the author feels supervision of these efforts by a government agency or direct regulation by the SEC might become necessary. *Id.* at 65-68. *See* text accompanying notes 164-81 *infra* on the recent REPORT OF THE JOINT TREASURY-SEC-FEDERAL RESERVE BOARD STUDY OF THE GOVERNMENT RELATED SECURITIES MARKETS which has recommended new and more extensive federal regulation of GNMA and related markets.

[5] Rustin, *Securities Firm's Flop Reveals Big Risks Run by Some Small Banks*, Wall St. J., Oct. 28, 1977, at 1, col. 6. The bank refused to accept delivery of the GNMA securities and its dealer was forced to cover at a loss of more than $220,000. *Id.*

[6] Recent scandels involving trading in commodity options, Great Britain and the United States have also signaled prospects of increased regulatory enforcement efforts.

[7] Commodity Futures Trading Commission Act of 1974, 7 U.S.C. §§ 1-22 (1976) [hereinafter cited as CFTC Act].

[8] Commodity Exchange Act § 545, 49 Stat. 1491 (1936) (currently codified at 7 U.S.C. §§ 1-22 (1976)).

[9] 7 U.S.C. § 2 (1976).

and articles . . . and all services, rights, and interests in which contracts for future delivery are presently or in the future dealt in."[10] Once the CFTC Act enacted the change in the definition of "commodity", the door was opened to the trading of financial futures contracts on commodity exchanges and boards of trade.

Responding to the economic needs of the increasingly unstable United States economy of the middle 1970's, the CBOT applied for and was granted approval from the CFTC to initiate trading in a contract for the future delivery of mortgage-backed securities guaranteed by the GNMA. Subsequently, the Chicago Mercantile Exchange obtained permission to initiate trading in futures contracts for the delivery of 90 day United States Treasury Bills. These futures contracts were for the delivery of a standardized quantity of interest rate sensitive financial instruments or securities on an agreed standard future date at an agreed price, determined by both the current and expected market value of the instruments.[11] Investors who expected to have free funds for investment in securities at a point in time in the near future could use the futures contracts to fix the cost and return of that future investment and thus be protected against the possibility that investment yields would decline (securities will rise in price and/or decline in return) in the interim period between the date the contract is made and the delivery date. Conversely, investors who expected to have securities for sale at a future date could use the futures contracts to protect themselves against the possibility that the selling price of these securities would decline in the interim.

Under the National Bank Act of 1864, ("Act")[12] a National Banking Association is permitted to purchase and sell for its own account only "investment securities."[13] The Act defines "investment securities" as "marketable obligations, evidencing indebtedness . . . in the form of bonds, notes and/or debentures. . ."[14] Clearly, equity issues and any form

[10] *Id.*

[11] The futures market can add significantly to efficient capital management by banks and other financial institutions that have a large percentage of their commitments in long-term, fixed-interest-rate instruments. Many bond portfolios contain older bonds carrying relatively low interest-rate returns. By taking advantage of a short-term, interest-rate futures market and taking either a long or short position on anticipated short-term, interest-rate changes, an institution can realize gains that will upgrade total investment returns. Banks can use futures in a long hedge by buying them to protect the government securities trading area against falling interest rates on future purchases. They can also use futures in a short hedge by selling them to hedge the cost of future CD purchases, Eurodollar borrowing, or federal funds transactions. INTERNATIONAL MONEY MARKET, TREASURY BILL FUTURES 19 (1977) [hereinafter cited as TREASURY BILL FUTURES]. *See generally* Lower & Ryan, *Futures Trading By National Banks*, 98 Banking L.J. 239 (1981).

[12] 12 U.S.C. § 21-215 (1976). The Act has been amended several times since its original passage in 1864.

[13] *Id.* § 24.

[14] *Id.* § 24(7).

of commodities or commodity futures lie outside the bounds of this narrow definition. The Act also states that "nothing herein contained shall authorize the purchase by the association for its own account of any shares of stock of any corporation."[15] In addition, the Comptroller of the Currency, whose office is charged with the primary responsibility for enforcing this provision of the Act,[16] has issued regulations declaring that an investment security "does not include investments which are primarily speculative in nature."[17] Thus, under the Act one can conclude that trading in financial futures is not a specifically authorized transaction, especially in view of the inherent speculative nature of commodity futures trading.

The Act provides two exceptions to the general rule prohibiting speculative investments. National Banking Associations are permitted to deal in speculative securities and stocks if they do so "solely upon the order, and the account of, [the bank's] customers. . ."[18] The Act further provides that a national bank can deal in speculative securities and stocks for its own account when the Comptroller of the Currency issues regulations creating exceptions to the Act's general prohibition of such activity.[19]

The Federal Reserve Act[20] also operates to restrict federal banks in the investments they can make. Section 4 of the Federal Reserve Act directs each federal reserve bank to keep informed of the general character of the investments made by its member banks in order to determine whether any bank is making undue use of bank credit for speculative trading in securities or commodities.[21] Possible sanctions for such activity are referred to in Federal Reserve regulations. The regulations require each reserve bank to give consideration to any information it might have on the character of investments made by a member bank in determining whether to extend credit to such bank.[22]

Various other federal statutes regulate speculative investments by federally insured lenders. Federal banking laws limit federal home loan banks in their investment of excess funds to "such securities as fiduciary and trust funds may be invested in under the laws of the state in which the federal home loan bank is located."[23] Furthermore, federal home loan banks are directed by regulation not to seek credit from the Federal Home Loan Bank Board for the purchase of securities.[24] Prior to 1976,

---

[15] *Id.*

[16] *Id.* § 1.

[17] 12 C.F.R. § 1.3(b) (1981).

[18] 12 U.S.C. § 24 (1981).

[19] *Id.*

[20] Federal Reserve Act of 1913, ch. 6, 38 Stat. 251 (codified in scattered sections of 12, 15, 18, and 31 U.S.C.).

[21] 12 U.S.C. § 301 (1976).

[22] 12 C.F.R. § 201.5(b) (1981).

[23] 12 U.S.C. §1431(h) (1981).

[24] 12 C.F.R. § 531.1(c) (1981).

federal savings and loan associations had been similarly limited to specific categories of investments, none of which include financial futures.[25]

In May of 1976, the Federal Home Loan Bank Board authorized the trading of federally guaranteed mortgage-backed securities ("Ginnie Maes") futures contracts by member banks in the Federal Savings and Loan System.[26] These banks had always dealt in mortgages and had engaged in trading the Ginnie Mae from the inception of the securities.[27] Thus, Ginnie Mae futures contracts were a natural vehicle for these banks to use to hedge their investments in mortgages and mortgage-backed securities against interest rate fluctuations.[28]

The use of the futures contracts as a hedge was especially prevalent in the period between the formation of a GNMA pool[29] and the issuance

---

[25] *See* 12 U.S.C. § 1464(c); 12 C.F.R. § 545.29 (1978), *as amended by* 43 Fed. Reg. 54,622 (1978) (codified in 12 C.F.R. § 545.29 (1981)).

[26] 12 C.F.R. § 545.29 (1978), *as amended by* 43 Fed. Reg. 54, 622 (1978) (codified in 12 C.F.R. § 545.29 (1981)).

[27] Ginnie Maes are codified pass-through securities by mortgage bankers and guaranteed by the Government National Mortgage Association (GNMA). The GNMA is a federal agency authorized to back that guarantee with the full faith and credit of the United States. 24 C.F.R. §§ 300.3, 300.5 (1981). These securities represent shares in a pool of government home mortgages that are created by a mortgage banker. GNMA guarantees Ginnie Mae holders the monthly payment of principal and interest on their shares of the mortgages in the pool regardless of whether or not the mortgagors make these payments to the mortgagee. The mortgagee is ordinarily a mortgage banker who has created the pool and issued the securities. The mortgage banker continues to handle all the administrative duties connected with the program, but Ginnie Mae holders have no recourse against the issuer. The sole recourse of holders is against GNMA. U.S. DEP'T. OF HOUSING AND URBAN DEVELOPMENT, ANALYSIS AND REPORT ON ALTERNATIVE APPROACHES TO REGULATING THE TRADING OF GNMA SECURITIES 1-66 (1978) [hereinafter cited as HUD REPORT]. *See* note 3 *supra*.

[28] One basic example of uses by a Federal Savings and Loan Association of GNMA futures to compensate for expected interest rate fluctuations is a short hedge. *See* note 30 *infra*. A bank may take a short hedge to protect the value of fixed-rate investments in that bank's portfolio, such as 30-year home mortgages, against devaluation caused by rising interest rates. By selling GNMA futures in a dollar-contract amount equal to its fixed-rate investment, a bank may be able to offset any expected increase in its current cost of money with earnings on the delivery of devalued GNMA securities. Since interest rates have risen between the time the futures contract was made and the delivery date called for in the contract, at the time of delivery the securities to be delivered will be selling far below the price determined in the futures market months earlier. As a result, the bank, which has taken the short position in this transaction, will make a profit on the futures contract amounting to the difference between what a bank charges and what it pays for the use of money. In this situation the bank earns a profit despite the fact that its cost of money may be increasing at the same time that its earnings on money it has invested has remained fixed.

[29] A GNMA pool is formed when a mortgage lender assembles a group of Veterans Administration (VA), Federal Housing Administration (FHA) or Farm Housing Administration (FMHA) mortgages (i.e., government mortgages) whose aggregate value is at least $1 million. The lender then files an application with the GNMA describing the mortgage lender and the mortgage pool that has been created. The application requests that the GNMA guarantee the timely payment of principal and interest on the mortgage-backed securities

of the securities backed by the mortgages in the pool. During the interim period, interest rate fluctuations are potentially the most costly for issuers or buyers of the new securities. Since prudent banking practices relied on trading in GNMA futures contracts, federal savings and loan associations were permitted, by the action of the Federal Home Loan Bank Board, to engage in such trading for hedging[30] purposes only. Savings and loan associations were limited, however, by having to match a GNMA futures transaction either directly against the association's firm commitments or against anticipated reinvestments in mortgage related securities during the forthcoming 12 month period.[31]

---

that the lender intends to issue. If all is in order the request is granted. The lender then issues and sells the GNMA-guaranteed securities after the mortgages making up the pool are first deposited for safekeeping with a federally or state regulated financial institution. Bar-Levav, *supra* note 3, at 45 (*citing* HUD REPORT, *supra* note 27, at 4 and Merrill Lynch Weld Capital Markets Group, *Prospectus for the Government Securities Income Fund* 6 (8th GNMA ser.) (December 18, 1978)).

[30] Hedging is defined by the Commodity Futures Trading Commission as:

> "Bona fide hedging transactions and positions shall mean transactions or positions in a contract for future delivery on any contract market, where such transactions or positions normally represent a substitute for transactions to be made or positions to be taken at a later time in a physical marketing channel, and where they are economically appropriate to the reduction of risks in the conduct and management of a commercial enterprise, and where they arise from:
>
> (i) The potential change in the value of assets, which a person owns, produces, manufacturers, processes, or merchandises or anticipates owning, producing, manufacturing, processing, or merchandising,
>
> (ii) The potential change in the value of liabilities which a person owes or anticipates incurring, or
>
> (iii) The potential change in the value of services which a person provides, purchases, or anticipates providing or purchasing.
>
> Notwithstanding the foregoing, no transactions or positions shall be classified as bona fide hedging . . . unless their purpose is to offset price risks incidental to commercial cash or spot operations and such positions are established and liquidated in an orderly manner in accordance with sound commercial practices. . ."
>
> 17 C.F.R. § 1.3(z)(1) (1981)

The Comptroller of the Currency has taken a narrower view of what a hedge is for banks engaging in financial futures transactions. In Banking Circular No. 79, the Comptroller authorized national bank participation in financial futures markets for hedging purposes only. This Banking Circular, issued in November 1976, required: "Each and every . . . futures contract, purchased or sold, must correspond to an appropriate cash transaction and only be undertaken to substantially reduce the risk of loss resulting from interest rate fluctuations." Comptroller of the Currency Banking Circular No. 79, November 2, 1976 *reprinted in* [1973-78 Transfer Binder] FED. BANKING L. REP. (CCH) ¶ 96,977, at 82,226 [hereinafter cited as Banking Circular 79]. This requirement was later revised and correspondence between each futures position taken and a specific cash position is no longer necessary, as long as the over all effect of participation in futures and forward markets is a reduction in a bank's exposure to the risk of interest rate fluctuations. *See* text accompanying notes 34-37 *infra*.

[31] 12 C.F.R. § 545.29(d)(2). It should be noted that, despite the strict limitations on trading set out in these regulations, abuses in GNMA futures trading have occurred. *See* text accompanying notes 3-4 *supra*.

Thus, with the single exception of the federal savings and loan association, it would seem that federal banking laws effectively precluded the participation of federally chartered banks in financial futures transactions. Nevertheless, the National Banking Act provides that national banking associations shall have the power "to exercise all such incidental powers as shall be necessary to carry on the business of banking. . ."[32] This provision of the Act eventually was relied upon as the statutory basis for granting permission to national banks to engage in financial futures transactions.

Opening the Door: The November 1976 Banking Circular[33]

The Comptroller of the Currency, who has primary responsibility for the administration of the national banking laws,[34] in November 1976 issued Banking Circular No. 79.[35] The circular granted permission to national banks to participate in the trading of both GNMA and Treasury Bill[36] futures, provided that they submit proposals for prior approval to the Comptroller. The grant of conditional permission was based on the theory that the use of financial futures by banks to hedge interest rate sensitive positions in other investment areas was a proper exercise of a bank's "incidental" powers to carry on the business of banking. To insure that the trading activity engaged in was actually "incidental" to normal banking activities, the November 1976 Circular required that each financial futures transaction: (a) correspond to a special cash position that was being hedged; and (b) be undertaken only to substantially reduce the risk of loss resulting from interest rate fluctations.[37]

---

[32] 12 U.S.C. § 24 (1976).

[33] Banking Circular No. 79, *supra* note 30.

[34] 12 U.S.C. § 1 (1976). Under the Futures Trading Act of 1978, PUB. L. No. 95-405, § 2, 92 Stat. 866 (codified at U.S.C. § 4a(g) (Supp. III 1979)) both the Treasury Department and the Federal Reserve Board must be consulted by the Commodity Futures Trading Commission (CFTC) before the CFTC acts on any application for the designation of a new futures contract in government issues. Any emergency act taken by the CFTC affecting the designation of contract markets must similarly await consultation with the Treasury Department and the Federal Reserve Board.

The Treasury Department had been concerned with the potential danger that the futures market might interfere with the Treasury's responsibility for managing the national debt, especially since the low margin requirements and proliferation of applications for new futures contracts increased the potential for trading abuses and delivery problems. Consequently, the Futures Trading Act of 1978 directs the CFTC to particularly consider the impact its contract designation actions will have on the debt financing requirements of the U.S. and the integrity of the underlying market for government securities. *See* text accompanying notes 137 *supra.*

[35] Banking Circular 79, note 30 *supra.*

[36] In November 1976, GNMA and 90-day Treasury Bills were the only financial instruments for which futures contracts were being traded. *See* text accompanying notes 23-28 *supra.* By 1981 an expanded variety of financial futures contracts were being traded on the various exchanges. These included contracts for the delivery of Treasury Bonds, 90-day commercial paper, and one-year Treasury Bills.

[37] Banking Circular 79, *supra* note 30, at 82,226.

In August 1977, the Comptroller of the Currency issued a supplement to the November Circular.[38] Along the lines of the earlier pronouncement, the supplement authorized national banks to participate in the "forward placement" or "delayed delivery" markets for GNMA and other U.S. government securities.[39] The supplement, however, prohibited the sale by national banks of "stand-by" options for the forward placement, or delayed delivery, of securities.[40] The supplement carefully pointed out that despite the fact that the national banking laws do not consider forward placement contracts as "investment securities,"[41] their purchase and sale was permissible because such transactions could be considered to be an activity incidental to banking.[42] The one proviso stated in the supplement was that a bank that wishes to invest in forward placement contracts must follow the Comptroller's accounting and control guidelines.[43]

The November 1979 Revision of Banking Circular No. 79[44]

On November 20, 1979, the Comptroller of the Currency issued a revision of Banking Circular No. 79. The circular was revised once again in March 1980.[45] The revisions made the accounting procedures for banks trading in financial futures more flexible to reflect better the economic reality of the transactions.[46] In addition, the revisions exempted futures

---

[38] Comptroller of the Currency Banking Circular No. 79. Supplement No. 1, August 1, 1977, *reprinted in* [1973-78 Transfer Binder] FED. BANKING L. REP. (CCH) ¶ 97,210, at 82,469 [hereinafter cited as Banking Circular 79 (Supp. 1)].

[39] *Id.*

[40] "Stand-by" options allow a forward placement or delayed delivery broker-dealer the discretion to deliver securities under a "stand-by" optional delivery contract. *Id.* The Comptroller has defined standby contracts as: "optional delivery forward placement contracts. The buyer of a standby contract (put option) pays a fee for the right or option to sell (deliver) an agreed upon amount of specified securities to the insurer of the standby contract at a specified price at a specified future date." Comptroller of the Currency Banking Circular No. 79 (2nd Rev. March 19, 1980), *reprinted in* [1979-80 Transfer Binder] FED. BANKING L. REP. (CCH) ¶ 98,190 at 84,275 [hereinafter cited as Banking Circular 79 (2nd Rev.)].

[41] Banking Circular 79 (Supp. 1), *supra* note 38, at 82,469 *citing* 12 U.S.C. § 24(7) (1976).

[42] Banking Circular 79 (Supp. 1), *supra* note 38, at 82,469.

[43] *Id.*

[44] Comptroller of the Currency Banking Circular No. 79 (Revised), 44 *Fed. Reg.* 66,722 (1979), *reprinted in* [1979-80 Transfer Binder] FED. BANKING L. REP. (CCH) ¶ 98,038, at 83,997.

[45] Banking Circular 79 (2nd Rev.), *supra* note 40.

[46] *Id.* at 84,276-77. Until the 1980 revision the only permissible method of valuing futures and forward contracts was the mark to method. Futures and forward contracts can now be valued by either the mark to market method or by the mark to the lower of cost or market method. *Id.* at 84,276. Another change in the 2nd Revision was that now the board of directors can delegate their monthly obligations to review all outstanding contract positions and ensure that the limits on futures, forwards and standby contract positions that they have established have not been exceeded. *See* text accompanying notes 74-81 *infra*. Now a duly authorized committee of the board or the bank's internal auditors can perform this function.

and forward contracts associated with hedging of mortgage banking operations from the circular's accounting requirements.[47] Thus, in place of the prior requirement that a bank match each hedged financial futures transaction with a specific and identified corresponding investment position, the Comptroller now required that financial futures transactions result in a reduction of the bank's overall risk.[48] By looking to the effect of financial futures transactions on the bank's overall investment picture rather than to a position-by-position matching of investments with financial futures hedges, the Comptroller finally had provided banks with the flexibility they needed to effectively reduce their interest rate sensitive risks by employing financial futures in their strategy.[49] Because of the practical difficulties in matching and identifying corresponding investment positions, the prior requirement of the original Banking Circular No. 79 (1976) had proved largely unfeasible and difficult to administer[50] in any case.

In addition to permitting banks to engage in financial futures transactions to reduce the overall exposure of the bank's investment portfolio, the Comptroller's March 1980 Circular allowed for other uses of financial futures. The circular permitted banks to engage in financial futures transactions as part of their trading account-dealer activities, as long as such transactions are "in accordance with safe and sound banking practices" and are "reasonably related to the bank's legally permitted trading activities" (i.e., not being treated as trading positions in their own right, but only as part of hedges associated with other trading positions).[51] The revised circular further permitted banks to utilize financial futures transactions to hedge[52] against interest rate exposure created by

[47] Banking Circular 79 (2nd Rev.), *supra* note 40, at 84,274. Futures and forward contracts associated with hedging of mortgage banking operations may be accounted for in accordance with generally accepted accounting principles. *Id.* at 84,277.

[48] Reduction of a bank's overall risk encompasses the exposure and sensitivity of a bank's aggregate investment position to interest rate fluctuations. An example of how the requirement of risk reduction works in practice is the following example: A bank, looking ahead to the next three months, sees that most of its funds will be tied up in low-yield, long-term investments at a time when, in order to compete with other financial institutions, it expects to raise the rates of interest it is paying to its sources of funds. To protect itself against expected increases in short-term rates, the bank would sell an interest rate contract for delivery in 3 months. TREASURY BILL FUTURES, *supra* note 11, at 20.

[49] *See* Banking Circular 79 (2nd Rev.), *supra* note 40, at 84, 274; *cf.* Banking Circular 79 *supra* note 30.

[50] A highly placed source within the Comptroller's office indicated during a research interview, that the bookkeeping burden of matching each financial futures transaction with a corresponding cash position proved to be too burdensome to be feasible; it simply was not worth the time and effort involved in keeping track for a bank to participate in the financial futures market. In addition, the matching requirement was insufficient insurance that only genuine hedging was taking place. Since records could be easily manipulated to make any non-hedging activity with alleged "matches", the requirements could not effectively safeguard against speculative activity.

[51] Banking Circular 79 (2nd Rev.), *supra* note 40, at 84,276.

[52] *Id.* at 84,274. *See* note 30 *supra.*

undesired mismatches of assets and liabilities, where one is interest rate sensitive and the other is a fixed rate. In this way, a bank could structure future matches of assets and liabilities with similar sensitivities to interest rate fluctuations. Furthermore, by using financial futures hedges to increase the liquidity of existing positions, the maturities of asset-liability matches could be more easily adjusted to reflect expected interest rate fluctuations.[53]

The 1980 Circular contains certain limits on the kinds of transactions in which a bank can enter. Because a "spread"[54] in the futures market will be profitable only if a bank is correct in its estimation of the future price relationships between the contracts being spread, the Comptroller views such "spreading" activity as being outside the exception that permits banks to trade in financial futures.[55] Similarly, arbitrage activities in the futures market can be considered to fall outside that permissive exception, except where the subject security is already owned by the bank. For example, a bank would be allowed to enter into a short futures position on a Treasury bond if the futures price was higher than the cost of the bond in the bank's trading account.

Recognizing the need for a uniform accounting treatment of financial futures transactions, in the revised banking circular[56] the Comptroller established a uniform reporting standard for national banks. The circular required all futures positions to be valued monthly by a consistent method of either mark to market or mark to the lower of cost or market.[57] Further, the bank must recognize any losses reflected in such monthly valuations as a current expense item and any gains as a current income item.[58] Because this requirement often may result in a different accounting treatment for each side of a hedge, the accounting profession has objected strenuously to this provision of the revised circular. The Comptroller's office has indicated that it would be willing to accept a reasonable alternative to this requirement provided an appropriate industry-wide body such as the American Institute of Certified Public Accountants or Financial Accounting Standards Board would adopt the alternative as a uniform standard.[59] The accounting profession has con-

[53] Banking Circular 79 (2nd Rev.), *supra* note 40, at 84,275-76.

[54] A "spread" or "straddle" futures position consists of a long position in a nearby delivery month which is coupled with a short position in the same commodity taken out in a later delivery month, thus locking in a particular difference or spread in price between the two delivery months.

[55] *See* Banking Circular 79 (2nd Rev.), *supra* note 40, at 84,275-76.

[56] *Id.*

[57] *Id.* at 84,276.

[58] *Id.*

[59] BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM, STATEMENT OF POLICY CONCERNING BANK HOLDING COMPANIES ENGAGING IN FUTURES, FORWARD AND STANDBY CONTRACTS ON U.S. GOVERNMENT AND AGENCY SECURITIES, 45 Fed. Reg. 61,595 (1980), COMM. FUT. L. REP. (CCH) ¶ 21,090 (1980) (*codified as* 12 C.F.R. § 225.142(d) (1981)) [hereinafter cited as BANK HOLDING COMPANY POLICY STATEMENT]; Letter to Paul Jons, Executive Vice Presi-

sidered reasonable alternative accounting standards to those required by the revised banking circular.[60]

In essence then, the revisions of Banking Circular No. 79 reiterated the proposition that banks may engage in financial futures transactions pursuant to their incidental powers to carry on the business of banking and prescribed policies and procedures consistent with that approach. With respect to banking procedures, the most important change was the elimination of the requirement that a bank obtain permission from the Comptroller prior to engaging in financial futures transactions.[61] While lifting the "permission" requirement, the Comptroller placed into effect new regulatory and accounting controls designed to prevent unauthorized futures trading and other potential abuses by bank personnel.[62]

Indicative of the change in attitude toward bank trading of financial futures contracts was the Comptroller's pronouncement that it viewed such contracts as "neither inherently prudent or imprudent," and the declaration that such contracts may be effectively used to reduce a bank's risk and exposure to interest rate fluctuations.[63] Additionally, abandoning the requirement of specific correspondence between financial futures and cash positions allowed a more flexible use of financial futures in the context of administration of a bank's entire investment portfolio. By eliminating the position-by-position approach and hedging an entire portfolio in the aggregate, a bank could reasonably ensure that the net effect of its financial futures trading would be a reduction rather than an increase in the bank's risk.

Despite the numerous revisions contained in the 1980 Circular, neither the Revised Banking Circular[64] nor the joint Federal Reserve Board-Comptroller of the Currency-Federal Deposit Insurance Corporation Policy Statement[65] lifted the prohibition against banks using futures activities for speculative purposes. In view of the vigorous enforcement

---

dent, Chicago Board of Trade from Scott Ryan, Executive Advisor for Banking & Securities, Office of the Comptroller of the Currency (March 19, 1980) at 2. There is no Generally Accepted Accounting Principle ("GAAP") yet established for futures and forwards and in fact, accounting firms have different methods of treating these contracts. This divergent treatment is clearly unacceptable from a regulatory point of view and it is the reason the Comptroller felt compelled to establish uniform reporting standards pending the development of an acceptable GAAP standard.

[60] American Institute of Certified Public Accountants' ("AICPA") paper, "Accounting for Forward Placement and Standby Commitments and Interest Note Futures Contracts." The AICPA proposals were submitted to the Financial Accounting Standards Board in December 1980.

[61] *See* text accompanying notes 34-37 *supra*.

[62] Banking Circular 79 (2nd Rev.), *supra* note 40, at 82,275-77.

[63] *Id.* at 84,275.

[64] Banking Circular 79 (2nd Rev.), *supra* note 40.

[65] Policy Statement, Board of Governors of the Federal Reserve System, 45 Fed. Reg. 18,120 (1980); Policy Statement, Federal Deposit Insurance Corporation, 45 Fed. Reg. 18,116 (1980). These policy statements are virtually identical in content to Banking Circular 79 (2nd Rev.), *supra* note 40.

posture taken by the Comptroller of the Currency regarding the federal banking laws' anti-speculative provisions, all present indications are that this prohibition will continue.

Expanding the scope of its previous policy statements, the Federal Reserve Board, in a recent policy statement, warned bank holding companies not to engage in speculative trading in futures contracts, forward or standby contracts.[66] The Board noted that it will monitor closely the trading activity of the parent holding companies to ensure that their activity is consistent with the "safe and sound" banking guidelines.[67] Further, holding companies should approve written policies in connection with planned futures transactions.[68] Such policies must be within prudent parameters and banks are to establish internal controls and audit programs to monitor said activity.[69] Of interest is the portion of the statement which notes that the holding company should consider the interest rate exposure of its non-banking subsidiaries but not that of its banking arm. Futures activity involving banking subsidiaries are to be reflected on that bank's books and reports and not that of the parent.[70]

Regulatory and Accounting Controls

Though they represent a liberalization of prior rules and regulations, the Revised Banking Circular[71] and the Joint Policy Statement[72] are by no means a carte blanche for any national bank to dive into the financial futures market. Despite the fact that prior approval from the Comptroller is no longer a prerequisite to a bank's engaging in financial futures trading, significant restrictions and controls on the bank's financial futures trading activity still exist. Because of the vast potential for abuse by individual bank employees, past abuses in the trading of foreign exchange contracts (of the kind that led to the demise of the Franklin National Bank),[73] and perhaps a general wariness of this area on

---

[66] BANK HOLDING COMPANY POLICY STATEMENT, *supra* note 59.

[67] 12 C.F.R. § 225.142(e) (1981). Under present requirements a majority of the companies' directors must sign its annual report.

[68] *Id.* at § 225.142(b).

[69] *Id.*

[70] *Id.* at § 225.142(c).

[71] Banking Circular 79 (2nd Rev.), *supra* note 40. This revised circular is addressed to national banks only.

[72] *See* note 65 *supra*. The Federal Reserve Board Statement is addressed to state banks which are members of the Federal Reserve System. The Federal Deposit Insurance Company statement is addressed to state non-members.

[73] Losses in foreign exchange transactions, as high as an estimated $37 million, played a major role in the demise of the Franklin National Bank. The facts leading up to the financial collapse of the Franklin National Bank, the largest bank failure in United States history, and the role of the Comptroller of the Currency and the FDIC in handling it are briefly recounted in *In re Franklin National Bank*, 381 F. Supp. 1390 (E.D.N.Y. 1974); *In re Franklin National Bank Securities Litigation v. Andersen*, 532 F.2d 842 (2d Cir. 1976); *Huntington Towers, Ltd. v. Franklin National Bank*, 559 F.2d 863 (2d Cir. 1977); and *In re Franklin National Bank Securities Litigation*, 445 F. Supp. 723 (E.D.N.Y. 1978).

the part of the national banking authorities, trading in financial futures is now under rigorous control requirements.

One important change is that the primary responsibility for establishing and enforcing a particular bank's standards and procedures for financial futures trading now lies with the bank's board of directors rather than with the Office of the Comptroller of the Currency.[74] Current regulations require that before a bank makes its first financial futures trade, the bank must draw up its own written statement that sets out its financial futures trading policies and procedures.[75] Also prior to trading, the statement must be endorsed by the bank's board of directors and filed with the Regional Administrator of National Banks.[76] Included in this filing, besides the written policy statement, must be specific contract position limits agreed upon by the board of directors and examples of the blank internal record keeping forms that the bank will use to monitor its trading.[77] The specific contract position limits agreed upon by the board of directors must include futures and forward trading limits both for individual traders and on total outstanding contracts.[78] The basis for these limits must be fully explained in the bank's submission to the Regional Administrator.[79] Any subsequent deviation from stated individual or gross trading limits can not be undertaken without prior written approval from the Comptroller,[80] and then the trades in question must be subsequently ratified by the board of directors.[81]

The written policy statement must specify the bank's trading strategies and how these strategies will meet the required standard of reducing the bank's risk and overall exposure to interest rate fluctuations.[82] Furthermore, in line with the restricted statutory basis for permitting banks to engage in financial futures trading (as part of their "incidental powers necessary to carry on the business of banking"),[83] the policy statement must outline the interrelationship between the bank's trading strategies and its other banking activities. The Investment Securities Examination Procedures section of the Comptroller's Handbook for National Bank Examiners sets out the criteria for determining whether financial futures contracts have a reasonable correlation to a bank's business needs:

---

[74] *See* Banking Circular 79 (2nd Rev.), *supra* note 40, at 84,275 and text accompanying notes 53-55 *supra*.

[75] *See* Banking Circular 79 (2nd Rev.), *supra* note 40, at 84,275-76.

[76] *Id.* at 84,278.

[77] *Id.*

[78] COMPTROLLER'S HANDBOOK FOR NATIONAL BANK EXAMINERS, § 203.4 (20) at 2 (Feb. 1980 ed.) [hereinafter cited as COMPTROLLER'S HANDBOOK].

[79] *Id.*

[80] *Id.* § 203.4(21) at 2.

[81] *Id.* § 203.4(22) at 2.

[82] *Id.* at 2-3.

[83] 12 U.S.C. § 24(7) (1976).

(1) Comparison of the contract commitments and their maturity dates with those of the cash positions being hedged;
(2) Comparison of the amounts of outstanding futures contract commitments with the amounts of the hedged cash positions; and
(3) The extent of the correlation between expected interest rate movements on the futures contracts and on the hedged cash positions.[84]

The bank also must submit detailed descriptions of the internal control system that has been established to prevent unauthorized trading and other possible trading abuses.[85] Bank record keeping systems must be sufficiently detailed to permit a National Bank Examiner to determine whether operating personnel have followed the procedures and acted in accordance with the stated objectives of the bank's trading policy.[86] General ledgers should, at a minimum, include the type, amount, maturity date, cost and current market price of each outstanding financial futures contract.[87] Amounts held in margin accounts should be recorded and these figures should be updated, as should all deferred gains or losses on contracts held.[88] All traders must use a pre-numbered trade ticket that records the trade date, the nature of the transaction, the contract type, the quantity and price of the contract, the reason for the trade and the appropriate cash positions being hedged.[89]

Generally, the bank should account for all transactions on a mark to market or lower of cost or market basis.[90] The bank should make an exception to this general rule only when a financial futures transaction is specifically linked to a particular investment position. In such cases, the bank can carry unrealized gains and losses until either the investment position or the financial futures position is closed out, which ever occurs first.[91]

The bank should receive periodic statements from the bank's futures commission merchants ("FCMs").[92] The statements should reflect trading

[84] COMPTROLLER'S HANDBOOK, *supra* note 78, § 203.3(17) at 5.
[85] Banking Circular 79 (2nd Rev.), *supra* note 40, at 84,278.
[86] COMPTROLLER'S HANDBOOK, *supra* note 78, § 203.3(16) at 4.
[87] *Id.*
[88] *Id.* § 203.4(28) at 2.
[89] *Id.* § 203.4(24) at 2.
[90] *Id.* § 203.3(16) at 2; § 203.4(35) at 3.
[91] *Id.* § 203.4(35) at 3.
[92] The CFTC Act defines a futures commission merchant ("FCM") as, "individuals, associations, partnerships, corporations, and trusts engaged in soliciting or in accepting orders for the purchase or sale of any commodity for future delivery on or subject to the rules of any contract market and that, in or in connection with such solicitation or acceptance of orders, accepts any money, securities, or property (or extends credit in lieu thereof) to margin, guarantee or secure any trade or contracts that result or may result therefrom." Commodity Futures Trading Commission Act of 1974, 7 U.S.C. § 2 (1976).

activity for the period, open positions at the end of the period and the position's market value, any unrealized gains and losses and any cash balances in bank accounts.[93] The bank should prepare weekly reports for an appropriate committee of the board of directors and these reports should reflect the same information contained in the FCM's statements.[94]

The bank's internal control system should have features that separate the trading, record keeping and trading review functions, so as to prevent any unauthorized trading and/or bank employee abuse of the bank's trading system for personal gain. At the same time, the bank's internal controls should be adequate to assure adherence to the bank's written trading policy.[95] Only authorized trained personnel should engage in actual trading. Trading procedures authorized and approved by the bank's board of directors should be formalized and documented in a bank manual.[96] The bank should notify its FCMs in writing that they may trade with only those persons whom the bank informs the FCM are authorized traders.[97] Any time a bank employee's authorization to trade for the bank is revoked, the bank should notify the appropriate FCM in writing immediately.[98]

Accounting records should be maintained and controlled by non-trading personnel.[99] Incoming trade confirmations should be received by someone independent of both the trading and record keeping functions and verified to the trade tickets by that person.[100] Similarly a person in the same independent position should receive the FCM statements and reconcile the statements to all the bank's accounting records as well as to price listings from a published source.[101] Detailed subsidiary ledgers should support all financial futures trading activities and the bank should post the amounts daily to the general ledger.[102] Internal auditors should perform tests periodically to check on the efficacy of bank accounting and control procedures. The bank must also document all the required accounting procedures in a procedures manual.[103]

Bank Trust Accounts

National banks which serve in a trustee capacity for various customer trust funds (i.e., Pension Funds, Institutional Investment Trusts, etc.) and which are interested in entering the financial futures

---

[93] COMPTROLLER'S HANDBOOK, *supra* note 78, § 203.4(30) at 2-3.
[94] *Id.* § 203.4 at 3.
[95] *Id.* § 203.3(16) at 5.
[96] *Id.* § 203.4(18) at 2.
[97] *Id.* § 203.4(19) at 2.
[98] *Id.*
[99] *Id.* § 203.4(25) at 2.
[100] *Id.* § 203.4(27) at 2.
[101] *Id.* § 203.4(31) at 3.
[102] *Id.* § 203.4(29) at 2.
[103] *Id.* § 203.4(26) at 2.

market for the benefit of the trust funds, must consider not only their Employee Retirement Income Security Act ("ERISA")[104] and state law responsibilities, but also promulgations by the Comptroller of the Currency.[105] Under 12 U.S.C. § 92(a), the Comptroller has the authority to regulate trust activities of national banks. The Comptroller's regulations regarding trust funds provide that a bank may invest funds, other than commingled funds, in any investment permitted by the trust instrument and not in violation of the local laws and applicable ERISA provisions.[106]

National banks which maintain commingled trust funds are more limited in the investment area, especially futures trading. The regulations control investment flexibility by a list of permissible transactions which a bank can make with commingled funds.[107] This list does not make reference to commodity futures as a permissible vehicle for investments. However, the regulation leaves the bank with an alternative, by permitting it to "invest the pooled funds in *such other manner as may be approved (in writing) by the Comptroller* (emphasis added)."[108]

The Comptroller's Trust Banking Circulars began to recognize the economic need of commingled funds to hedge positions in the futures market, since such funds generally invest in interest rate sensitive short term financial instruments.[109] Comptroller's Staff Interpretive Letter No. 62 permitted a commingled fund for educational institutions to hedge its assets with Treasury Bill futures.[110] However, the respective trust documents had to contain language authorizing such transactions and granting the trustee the necessary powers to so effect them.

Presently, it appears that the Comptroller would not have major objections to a bank utilizing the financial futures markets for its ERISA portfolios, provided that the market was being used as a hedge and not as a speculative vehicle. Since such investments would be protective tools, the investments reasonably would meet ERISA's "Prudent Rule" requirements.[111] The "Prudent Rule" concept was amplified in Trust

---

[104] Employee Retirement Income Security Act of 1974, Pub. L. No. 93-406, 88 Stat. 829 (1974) [hereinafter cited as ERISA].

[105] 12 U.S.C. § 92a; 12 C.F.R. §§ 9.11-9.22 (1979). *See* Scott, *The Dual Banking System: A Model of Competition and Regulators*, 30 *Stan. L. Rev.* 1,6 (1977).

[106] *See generally* 12 U.S.C. § 92a and ERISA §§ 514(a) & 514(b)(2)(A); RESTATEMENT (SECOND) OF TRUSTS § 816 (1959).

[107] 12 C.F.R. § 9.18.

[108] *Id. See* Comptroller of the Currency, Trust Banking Circular No. 14 (June 26, 1979) *reprinted in* FED. BANKING L. REP. (CCH) ¶ 59,304 [hereinafter cited as Trust Banking Circular No. 14].

[109] *Id.* Comptroller of the Currency, Trust Banking Circular No. 2 (December 19, 1979), *reprinted in* FED. BANKING L. REP. (CCH) ¶ 59,292; Comptroller of the Currency, Press Release No. 15 (November 2, 1976).

[110] 12 C.F.R. § 9.18 (September 25, 1978), FED. BANKING L. REP. *(CCH)* ¶ 85,137 (Interpretive Letters).

[111] ERISA § 404(a)(1)(b). *See* R. MURPHY, R. POSNER, W. CHADWICK, R. MILNE, S. SMIDT, W. GRAY AND R. BLINT, EVOLVING CONCEPTS OF PRUDENCE: THE CHANGING RESPONSIBILITIES OF THE INVESTMENT FIDUCIARY IN THE AGE OF ERISA (1976). Although Trust Banking Cir-

Banking Circular No. 15.[112] The circular, among other things, states that ERISA's "Prudent Rule" will govern employee plans. However, it is clear that for the Comptroller to approve trading in financial futures by such funds, he must first be satisfied, by initial and ongoing review, that the bank's trading policies are consistent with the Rule's intent. Thus, we can reasonably conclude that if the bank's trading policies are structured to protect trust assets by hedging, and thereby satisfy the "Prudent Rule" from a prophylactic viewpoint, the Comptroller's concerns would be equally satisfied.[113]

In the winter of 1979-80, the Comptroller issued an approval letter to Chicago-based Harris Trust & Savings to trade long-term Treasury Bonds for its commingled, personal trusts.[114] The letter was the first known instance of manifested approval by the Comptroller for a bank to trade futures for its trust department, rather than through a dealer from its own account activities. Although an official of the Harris bank was quoted to say that the reason the bank sought approval from the Comptroller was "just as a matter of policy,"[115] there are other more consequential reasons for a *state bank* to seek such approval.

State banks that are members of either the Federal Reserve System, the FDIC, the Federal Savings and Loan Insurance Corp., or the Federal Loan Bank may find themselves under overlapping state and federal jurisdiction. Membership in such an organization arguably subjects the bank to the Comptroller's regulations as well.[116] Further, should a state bank seek favorable tax treatment for pooled trust accounts, the bank certainly will be subject to the rules and regulations of the Comptroller and the Federal Reserve.[117]

Margin Requirements[118]

Banks encountering commodities trading practices for the first time shall have to adjust to the different procedures necessitated by the

---

cular No. 14, note 108 *supra*, dealt with "forward contracts," it noted that management of employee benefit trust funds must be in conformity with ERISA provisions. The conformity requirement does not mean that ERISA would preempt the Comptroller's jurisdiction over the bank administered trust area but that the Comptroller would be primarily concerned with the bank's policies governing "forward" transactions in compliance with ERISA.

[112] Comptroller of the Currency, Trust Banking Circular No. 15 (July 13, 1979), *reprinted in* FED. BANKING L. REP. (CCH) ¶ 59,305. *See* CONTROLLER'S HANDBOOK FOR NATIONAL TRUST EXAMINERS, Opinion 9.4070, *reprinted in* FED. BANKING L. REP. (CCH) ¶ 59,251.

[113] Modern portfolio theory requirements that one should diversify the types of investment instruments the portfolio trades or maintains may also withstand the test of the "Prudent Rule." *See generally* Russo, Bachelder, & Grala, *Employee Plan Trading In Commodity Futures*, 37 WASH. & LEE L. REV. 811 (1980).

[114] *Comptroller Gives Harris Bank Trust Free Run to Trade T-Bond Futures*, SECURITIES WEEK, February 11, 1980, at 9.

[115] *Id.*

[116] *See generally* 12 U.S.C. § 321 (1976), 12 U.S.C. § 1470 (1976), 12 U.S.C. § 1818, 12 U.S.C. § 1464(n)(1) (Supp. I 1980).

[117] I.R.C. §§ 401, 584(a)(2); Treas. Reg. § 9.18 (1975); Rev. Rul. 56-267, 1956-1 C.B. 206.

highly volatile nature of such activity. Banks are liable to the FCM for margins—technically on a daily basis. Margin requirements in the futures area are vastly different in both amount and function from those in the securities market.[119] In futures trading, margins are not deposits for securities bought, nor is there any balance owed after a margin payment has been made. Margin functions in the futures markets as both earnest money (a good faith deposit) and as a fund that enables fluctuations against a trader's market position to be settled in cash, on a daily basis.[120] Thus, both the buyer and the seller of a futures contract put up margin money and when either's margin fund falls below a certain level by a succession of losses, additional margin money is due. In any case, margin requirements in the futures market are lower, on a percentage of commitment basis, than in almost any other trading area, and there are no margin requirements whatsoever in the privately traded forward placement or standby options markets.[121]

---

[118] On each financial futures contract transaction, both parties to the transaction, the buyer and seller of the contract, post margin funds. The full transaction price is not transferred until delivery of the subject securities in the settlement month. The minimum margin per contract is similar to a performance bond and is determined by the maximum daily limit on the price fluctuation of the contract. Thus margins on financial futures transactions are not downpayments or payments for equity. There is no interest due on any "unpaid balance." The contract is marked to market on a daily basis and there is a consequent daily cash settlement of gain or loss on the contract that flows from the loser to the gainer reflecting that day's price fluctuations in the contract's value. OFFICE OF THE COMPTROLLER OF THE CURRENCY, FUTURES & FORWARDS TRAINING MATERIALS, FUTURES LESSON PLAN, Definitions (1980). When the aggregate of such settlements deplete the initial margin below a fixed variation "maintenance" margin level, the margin fund must be replenished, at least up to the variation margin level, by the party who has sustained the losses on the contract. The replenishment must occur before the start of the next day's trading session. *See* COMM. FUT. L. REP. (CCH) ¶ 317, at 1064-1065 (1979).

[119] Margins in the securities market are downpayments on securities purchased. Interest is owed on the unpaid balance of the securities' purchase price. Margin requirements for such purchases are a fixed percentage of the purchase price of the securities at the time they are purchased and have no relation to possible subsequent price movements in the value of the securities. Money is owed by the buyer to the securities dealer through whom the purchase was made, not to any seller of the securities involved.

[120] *See* note 119 *supra*.

[121] Lower margin requirements are not the only significant difference between the forward placement/standby option market and the financial futures market. Financial futures transactions are conducted on an exchange with the clearing house acting as the other party to each participant. Forward placement and standby contracts are made directly between the two parties involved without any outside involvement. Futures contracts are traded on standardized terms, their price determined by the freely competitive marketplace. Forward and standby contracts can be freely negotiated and made up to suit the specifications and particular needs of each party, their price determined only by each party's relative bargaining position and negotiating ability.

Finally, there is a distinction between the subject matter of futures and forward transactions. A forward contract is a sales contract for the sale of a security that is delivered on a specific date in the future. A futures contract is a contract to deliver a security on a specific future date pursuant to a sale to be executed at that time, on terms presently agreed upon.

Whatever the distinction, empirical tests show that a far greater percentage of forward

Proposed legislation in Congress may make margin requirements for futures trading even more complex.[122] Legislation introduced by Senate Banking Committee Chairman, William Proxmire, would have margin requirements for financial futures trading set by the Federal Reserve Board.[123] Chairman Volcker of the Federal Reserve Board has expressed reluctance to assume the heavy responsibility entailed in such a complex regulatory program.[124]

Legal Liabilities

Banks entering the financial futures market should consider the wide range of potential legal liability which they may incur from trading in financial futures. Under the Financial Institutions Regulatory and Interest Rate Control Act of 1978,[125] the Comptroller of the Currency has the power to assess maximum penalties of up to $1,000 a day for viola-

---

than futures contracts have resulted in actual delivery of securities rather than settlement by pairing-off before the contract settlement date. Thus, although the futures market is safer because of the characteristics mentioned above, some participants prefer the less standardized and more flexible forwards market especially if the initial and daily margin requirements of the futures market pose a problem. *See* note 118 *supra*.

[122] Senator William Proxmire, Chairman of the Senate Committee on Banking, Housing and Urban Affairs, introduced S.2074 in 1980. The bill would have amended the Federal Reserve Act to authorize the Board of Governors of the Federal Reserve System to establish margin requirements for transactions in financial instruments. S.2074, 96th Cong., 2d Sess. § 23B(a) (1980). The margin requirements would cover both downpayments on cash purchases of financial instruments and minimum deposit requirements in connection with a futures contract involving a financial instrument. *Id.* The bill also provided that the Board would require all market participants to submit detailed reports on their trading activities, and that all federal agencies collecting information on these markets make that information available to the Board at its request. *Id.* § 23B(b). Finally, the bill gave the Board the power to seek injunctions for violations of "this section or the rules and regulations thereunder." *Id.* § 23B(c). The bill imposed fines of up to $100,000 or prison terms of up to five years for willful violations. *Id.* § 23B(e).

One of the most interesting aspects of the bill was its broad definitions. The bill defined "financial instrument" as any security not otherwise subject to the Board's margin authority under the Securities Exchange Act of 1934. Securities that fall within that category are "any currency, security or other evidence of indebtedness not subject to the provisions of section 7 of the Securities Exchange Act of 1934, gold bullion, silver bullion, bulk gold coins, bulk silver coins, or any other article, contract or right which the board determines has monetary characterisitic or is a store of value, but such term does not include any agricultural commodity." *Id.* § 23B(f)(1). "Futures contract" was defined by the bill as "a contract for the future delivery of any financial instrument which is traded on any contract market or similar entity located in the United States." *Id.* § 23B(f)(2). Although extensive hearings were held on S.2074, neither house of the 96th Congress passed the bill and it is not known at this time whether Senator Proxmire or anyone else intends to re-introduce it in any form in the new Congress.

[123] S.2074, 96th Cong., 2d Sess. (1980). *See* note 122 *supra* for a full discussion of the bill's provisions.

[124] *See* FED. BANKING L. REP. (CCH) at 4 (Other Legislative Action) (Letter of June 5, 1980); COMM. FUT. L. REP. (CCH) at 3 (Other Developments) (Letter of June 4, 1980).

[125] Financial Institutions Regulatory and Interest Rate Control Act of 1978, Pub. L. No. 95-630, 92 Stat. 3641 (codified in scattered sections of 12 U.S.C. (Supp. III 1979)).

tions of any provisions of the National Bank Act.[126] The Comptroller may assess the penalty not only against a violating bank, but against any bank officer director, employee or agent who violates the law. Possible liability in the financial futures area may accrue not only to the bank, its officers, directors and employees, but to any FCM carrying the account of a bank that trades financial futures for speculative rather than risk reducing purposes.[127] In addition, all of the above-mentioned parties are subject to a cease and desist order if the Comptroller of the Currency, the Federal Reserve Board or the FDIC[128] deems it appropriate. Bank officers and directors are also subject to a removal order on a finding that an act, practice or violation by the individual caused substantial financial loss to the bank and that such act, practice or violation demonstrated a willful or continuing disregard for the safety or soundness of the bank.[129] All those acting on the bank's behalf should consider these liabilities before engaging the bank in any financial futures trading activity and especially before departing from either the Comptroller's guidelines or the bank's own written trading policies and procedures.

Furthermore, the parent holding company of a bank may be obligated to disclose any material fact(s) relating to bank's trading activity to the Securities and Exchange Commission ("SEC"), possibly other agencies and to its shareholders through the various filings and shareholder reports.[130] A failure to properly disclose material facts may trigger enforcement proceedings by the SEC (and possibly other agencies), as well as potential shareholder lawsuits based on violations of federal and state securities laws.[131] The bank's outside auditors are also

---

[126] *Id.* at § 103(1) (codified at 12 U.S.C. § 93(b)(1) (Supp III 1979)).

[127] *Id.* The FCM's liability would come under the statutory category of "agent . . . participating in the conduct of the affairs of such [national banking] association." *Id.*

[128] *Id.* at § 107(a)(1) (codified at 12 U.S.C. § 1818(b)(1) (Supp. III 1979)).

[129] *Id.* at § 107(a)(1) (codified at 12 U.S.C. 1818(e)(1) (Supp. III 1979)).

[130] Under the Securities Exchange Act of 1934, issuers of securities must file: annual reports, referred to as Form 10-K, that include audited balance sheets, statements of income, and statements of source and application of funds covering the last two fiscal years. Any securities held by the bank as a result of futures or forward trading activity would have to be described in the summary of operations in the 10-K report. The issuer must also file quarterly reports, referred to as Form 10-Q, which are condensed financial statements which include an income statement, a balance sheet and statement of source and application of funds. A management analysis of income statements and additional financial information of significance to investors must also be included and these may contain references to the bank's financial futures or forward transactions. Any other materially important events such as large bank losses in connection with futures or forward trading must be the subject of a Current Report, Form 8-K, filed within 10 days after the close of the month during which the event occurred. The issuer would also have to include a report of the loss in Part II of the 10-Q filing. 1 FED. SEC. L. REP. (CCH) ¶ 174 (1977).

[131] *See, e.g.*, 15 U.S.C. § 77k(a) (1976) (civil liability to shareholders for misleading statements in registration statement); Securities Exchange Act Release No. 3230 (1942) (Rule 10b-5) (civil liability for material false statements made in connection with purchase or sale of any securities).

placed in a sensitive position as they too must be aware of and vigilant to the possibilities for accounting sleight of hand and bookkeeping magic hiding the true nature of a bank's financial futures trading activities.[132]

In addition to the potential liability flowing from any losses connected with failure to adequately structure and follow through on the elaborate accounting and control provisions presently mandated, there is the greater potential that the written policies and procedures created and adopted by the bank will prove inadequate to prevent unauthorized activity. Inadequate policies may also contribute to substantial losses in financial futures trading. In such cases, both the bank and the individual members of the bank's board of directors who have personally approved these policies may be open to lawsuits by bank depositors and shareholders.[133]

Regulatory Horizon

The 1978 renewal of the Commodity Futures Trading Commission Act[134] directed the CFTC to seek the advice of the Treasury Department and the Federal Reserve before authorizing any additional futures contracts in U.S. Government securities.[135] To assist them in meeting their statutory obligations, the Treasury Department and the Federal Reserve recently commissioned a joint study.[136] The study addressed two distinct but related problems. First, the study examined a possible adverse effect of futures trading on the efficiency and integrity of the underlying cash market for U.S. Government securities. Second, the study considered the possibility that the existence of a futures market which relies on the presumption that there will always be a deliverable supply of government securities may possibly have the effect of limiting the Treasury's flexibility in issuing government securities and managing the national debt.[137]

---

[132] *See, e.g.*, Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976); Escott v. BarChris Constr. Corp., 283 F. Supp. 643 (S.D.N.Y. 1968); Rusch Factors, Inc. v. Levin, 284 F. Supp. 85 (D.R.I. 1968).

[133] *See* note 73 *supra*, citing cases involving the financial collapse of the Franklin National Bank where both the bank and members of its Board of Directors were sued by bank holding company shareholders for losses suffered by the bank in its foreign exchange trading activities.

[134] Futures Trading Act of 1978, Pub. L. No. 95-405, 92 Stat. 885 (codified in scattered sections of 5, 7 U.S.C. (Supp. III 1979)).

[135] 7 U.S.C. 4a(g)(2)(i) (Supp. III 1979).

[136] TREASURY/FEDERAL RESERVE STUDY OF TREASURY FUTURES MARKETS (1979) [hereinafter cited in TD/FRB STUDY].

[137] *See generally id.* The apprehension concerning the Treasury's ability to manage the national debt centers on a scenario whereby it becomes apparent that certain individuals, by taking large cash, forward and futures positions in certain Treasury Bills, have been successful in cornering or at least squeezing the market for the Treasury Bills deliverable under a particular futures contract. The resultant shortage of supply and unnaturally high prices in that market would lead to an ever-worsening crisis as the date approaches when

On the first point, the study concluded that the futures market had only a salutary effect on the cash market for government securities, acting as a safety valve for the relief of pressures built up in the cash market.[138] The evidence showed that if any influence was exerted by activity in one market on the prices in the other, it was likely to be the cash market that influenced the futures market, not vice-versa.[139] The study found no evidence that the futures market diverted investment funds from the cash market; on the contrary, the futures market with its hedging capabilities has acted to reduce the risk and thus encourage the growth of investment in the cash market.[140] Finally, the study concluded, given the structure of current futures contracts,[141] there was "minimal" likelihood that Treasury Bond prices could be manipulated by speculators acting jointly in the cash market and the futures market.[142] The authors of the study could not be as sanguine about the likelihood of manipulation in the prices of the 3-month Treasury Bills.[143] Citing interviews with market participants, the study indicated that dealer positioning strategies, executed in both the cash and futures markets, may have succeeded in "squeezing" the secondary market price on one or two new issues of 3-month Treasury Bills.[144]

The study also considered the possibility that the futures market may have an inhibiting effect on the Treasury's exercise of its unfettered discretion in the management of the national debt. The study concluded that if the various futures exchanges were able to act quickly and effectively in dealing with any pending crises of supply, the needs of the futures market should never influence the Treasury in its debt marketing decisions.[145] Although the exchanges have specific rules and proce-

---

delivery would have to be made under the outstanding futures contracts for the issue. At that point if the exchanges did not step in to allow other comparable securities to be delivered under the contract calling for the delivery of the cornered or squeezed issue, the Treasury would be faced with a dilemma. If it proceeded with a debt issue of the small size necessary to cover the government's money needs, there would be too few securities to deliver under the outstanding futures contracts, and the market manipulators would have profitted greatly from their successful cornering or squeezing scheme. If, on the other hand, the Treasury issued enough securities to "break" the corner or squeeze, it would have issued more debt than necessary for the government's money need and wasted the taxpayers' money on interest paid out on unnecessary debt.

[138] *Id.* at 11-12.

[139] *Id.* at 12.

[140] *Id.*

[141] Future contracts for the delivery of Treasury Bonds may specify a "market basket" of bonds that are deliverable under the contract. A "market basket" contract may be fulfilled by the delivery of a few different issues of Treasury Bonds, rather than just one specific issue, each of which falls into a specified maturity range. For example, contract might provide that any Treasury Bond that matures 15-20 years from the date of delivery would qualify for the "market basket."

[142] TD/FRB STUDY, *supra* note 136, at 15.

[143] *Id.* at 14.

[144] *Id.*

[145] *Id.* at 15-17.

dures for dealing with such emergencies, the study questioned how aggressively the exchanges would implement them in cases of pending emergency.[146]

Although the study pointed out that no bank has yet failed as a result of involvement in financial futures, the study noted that trading in GNMA forward and standby contracts has threatened the solvency of some banks and that injudicious trading in commodity futures lead to the failure of a large U.S. bank's foreign banking subsidiary.[147] Despite the obvious distinctions between the forward and financial futures market,[148] these experiences do indicate the propriety of imposing additional safeguards on financial futures transactions.

The study recommended that in considering proposals for new futures contracts, the CFTC consider the probable supply and availability of the Treasury issues involved, with a view to making successful futures market "squeezes" or "corners" unlikely.[149] The study also recommended enactment of "Sunset" provisions requiring the FTC to review and reauthorize new contracts every few years. The study suggested that the FTC should deny approval for any futures contract dependent for its deliverable supply solely on a particular security yet to be issued.[150] In general, the study recommended that single security contracts be discouraged in favor of so called "market basket"[151] contracts that assure a broader deliverable supply of securities by providing that more than one issue can be delivered in satisfaction of a futures contract.[152] To minimize the possibility of manipulation, the study suggested improved data collection and monitoring of interactions between the futures and cash markets.[153] Finally, the study recommended in general, a "go slow" policy for the CFTC in authorizing additional financial futures contracts and proposed a joint CFTC, SEC and Treasury Department study of exchange regulations and investor protection measures, such as customer suitability standards, margin requirements and position limits.[154]

The prospect of financial futures trading becoming increasingly regulated should the above recommendations be followed, should not deter bank involvement in financial futures transactions. In fact, the financial futures market will become more attractive and suitable to banks. If the study's recommendations are rationally followed, the entire

---

[146] *Id.*
[147] *Id.* at 18.
[148] *See* notes 121 & 183 *supra* and accompanying text.
[149] TD/FRB STUDY, *supra* note 136, at 19-20.
[150] *Id.* at 20.
[151] *See* note 141 *supra.*
[152] TD/FRB STUDY, *supra* note 136, at 19-23.
[153] *Id.*
[154] *See generally* TD/FRB STUDY, *supra* note 136.

marketplace will become safer and less subject to manipulation and abuse.

An interesting and fruitful comparison can be made between the financial futures market and the forward market, which fulfills the same economic functions as the futures market, with respect to their existing and proposed regulatory structures and the attitudes taken toward those structures by the various federal agencies that oversee them. The existing and proposed futures market regulatory structures have been outlined above along with the attitudes of the Treasury Department and Federal Reserve Board toward them, as reflected in their 1979 joint study of futures markets.[155] While the difference between the way the futures and forward markets operate has been noted above,[156] an examination of two recent studies by the federal agencies that oversee the forward market will illustrate the differences in the two markets' current regulatory structures. The studies also explain why those agencies now favor a new regulatory structure for the forward market that will, for market participants, drastically reduce the existing differences in the way the two markets operate.

In 1978 the Department of Housing and Urban Development ("HUD") commissioned a study of the forward market for GNMA securities[157] that recommended the maintenance of the status quo regulatory situation in the forward market.[158] The study specifically recommended that, while HUD should encourage and promote any industry efforts at self-regulation, the agency should oppose any legislative proposals for increased federal regulation[159] before the industry has tried self-regulation.[160] The study warned that federal regulatory oversight would have to be imposed on the forward market if the GNMA forward dealers did not develop a workable and effective self-regulatory structure within a reasonable time.[161]

The noble experiment in allowing the Ginnie Mae forward dealers to develop an effective self-regulatory structure apparently failed. Two years after the HUD study, a joint study of the Treasury Department, the Federal Reserve Board and the SEC,[162] noting the serious abuses in the trading of Ginnie Mae forwards,[163] called for significant revisions in

---

[155] *Id.*

[156] *See* note 121 *supra*.

[157] HUD REPORT, *supra* note 27.

[158] *Id.* at 179. The status quo regulatory situation is a market that is virtually unregulated by any government agency other than the SEC. The SEC has always had the authority to initiate proceedings against dealers suspected of fraudulent, manipulative or deceptive practices.

[159] *Id.* at 180-81.

[160] *Id.* at 196-97.

[161] *Id.*

[162] REPORT OF THE JOINT TREASURY—SEC—FEDERAL RESERVE BOARD STUDY OF THE GOVERNMENT RELATED SECURITIES MARKETS (1980) [hereinafter cited as JOINT REPORT].

[163] *See id.* at 104-75.

the regulation of the forward market.[164] Significantly, the study singled out the lack of margin requirements in the forward market, the most important element distinguishing the forward from the futures market, as a practice which has resulted in a high degree of speculation. The increased speculation from the absence of margin requirements accordingly caused losses to market participants in cases where abusive practices were present.[165] The study's recommendation of increased regulatory oversights and more defined controls on forward market operations can be interpreted as an endorsement of the greater safeguards built into the futures market regulatory and control structure.

The study suggests a regulatory scheme in which the Federal Reserve Board has residual rulemaking authority for margin requirements in forward transactions. In the new scheme any margin rules the Federal Reserve promulgates would take precedence over those of the proposed rulemaking board.[166] If Congress gave such authority to the Federal Reserve Board and the Federal Reserve Board issued rules as to margin requirements in the forward market, such rules might be made applicable as well to the futures markets for the same securities.

If the study's recommendation of mandatory margin requirements for forward transactions is followed,[167] there would be a virtual disappearance of any significant practical difference between direct party-to-party forward transactions and the trading of futures contracts on organized exchanges and boards of trade.[168] Although it seems that the elimination of any difference between the two markets could only have a negative impact on the futures market, it is at present impossible to predict how large that impact would be. While forward trading would lose what many forward market participants consider to be the forward market's primary advantage over futures trading, it would gain the safety that previously attracted the most prudent investors to the futures market. Thus, the futures market might lose some of its most prudent investors to the forward market.[169] Despite margin requirements, the for-

---

[164] *Id.* at 4-6. The Federal Home Loan Mortgage Corporation ("FHLMC") is a wholly-owned subsidiary of the Federal Home Loan Bank System. Congress created the FHLMC in 1970 to issue and guarantee securities backed by pools of conventional (i.e. nonfederally insured or guaranteed) mortgages originating with member banks of the Federal Home Loan Bank System. *Id.* at 17-83. The FHLMC program for federally guaranteed mortgage backed pass-through securities and the GNMA program operate in very similar manners. One difference between the two programs is that the FHLMC is both the issuer and guarantor of the securities while the GHMA functions only as a guarantor. *See* notes 3, 27-29 *supra* on the GNMA program.

[165] JOINT REPORT, *supra* note 162, at 3, 206.

[166] *Id.* at 5, 226-27.

[167] *Id.* at 216.

[168] *See* note 121 *supra* on the existing differences between the futures and forwards markets.

[169] The precise net effect of mandatory margin requirements is not easily foreseen, but it seems likely that the forward market will lose some of its more speculative and under-

ward market would retain the advantage of relative flexibility in the amount, duration and other terms of the contracts being traded since they are negotiated individually by the parties involved in each transaction rather than standardized by the exchanges on which they are traded.[170] At the same time, those traders who could not afford the margins in the forward market would find the margin requirements of the futures market similarly inhibitive.[171] Since there is no way of measuring how large a group might be involved in each of the market shifts outlined above, the overall significance of these shifts on the continued health and vitality of the futures market cannot be determined at this time.

The joint study also recommended the creation of two new regulatory bodies to oversee the forward market. The proposed Federal Mortgage Backed Securities Rulemaking Board ("Board") would be composed of representatives of both bank and non-bank dealers and of public representatives including investors.[172] The proposed legislation would require dealers in forward transactions for government mortgage-backed securities to join and be subject to the rules by this self-regulatory organization.[173] The Board would promulgate rules to be followed by brokers and dealers of forwards, subject to the oversight of the Government Related Securities Oversight Council ("Council"), which would have the power to amend, disapprove or make substitutions for these rules.[174] The Board would have the authority to set both initial margin and maintenance margin requirements for forward trading.[175] The initial and maintenance margins would function much as futures margins do.[176] The Board could also establish financial responsibility and fair practice standards, including suitability and disclosure requirements, and other rules governing dealer operations.[177]

The Council, composed of the Secretary of the Treasury, the Chairman of the Federal Reserve Board and the Chairman of the SEC or their respective designees[178] would also be required to request and consider

---

capitalized participants, and perhaps attract the most prudent type of investor who previously confined his trading activities to the futures market. Thus a net gain in safety and reliability seems assured for the forward market, although the overall impact on it of proposed new margin requirements remains clear. *See, e.g.*, note 4 *supra* and accompanying text.

[170] *Id.*

[171] *See* note 118 *supra.*

[172] JOINT REPORT, *supra* note 162, at 4.

[173] *Id.* at 224.

[174] *Id.* at 5.

[175] *Id.* at 4-5.

[176] *See* note 118 *supra.*

[177] JOINT REPORT, *supra* note 140, at 5, 218. Other rules governing dealer operations might include competency and qualification requirements for dealers, brokers and their employees; registration and reporting requirements; and disciplinary and enforcement mechanisms. *Id.* at 218.

[178] *Id.* at 5.

the views of the Secretary of HUD, the Government National Mortgage Association and the Federal Home Loan Mortgage Corporation.[179] Brokers and dealers would have to register with the Council which would delegate this registration function to the SEC.[180] Finally, the Council, upon unanimous vote, would be granted the authority to extend the regulatory structure to encompass cash market transactions or other government related securities should that become necessary or appropriate.[181]

Conclusion

Because in the past certain banks have suffered great losses on GNMA forward transactions where abusive practices were present, banks have been reluctant to engage in both forward and futures transactions. The presence of organized exchanges, clearing houses and margin requirements in the futures market have provided more than adequate safeguards against the type of abuses that the forward market has experienced. Increased awareness of the high risks involved in forward trading and increased vigilance by the SEC, the national banking agencies, dealers, and banks themselves in this area has resulted in a reduced likelihood that such abuses will persist.[182] Finally, the proposed new regulation of forward markets will effectively close off the possibilities for abuse that have been most often exploited in the past.

As the past few years have dramatically demonstrated, interest rates are unlikely to return to the stable patterns of ten and twenty years ago when they fluctuated only gently and within a relatively narrow range. The persistent pressures of worldwide inflation will not disappear. In the coming months and years, banks will recognize that they may be needlessly exposing themselves to tremendous risks if they fail to provide for interest rate fluctuations by hedging their cash positions on the futures and forward markets.[183] The old image of futures trading

---

[179] *Id.* at 221.

[180] *Id.* at 5, 223.

[181] *Id.* at 6, 222-23.

[182] *Id.* at 208.

[183] On July 2, 1981, the Federal Home Loan Bank Board issued a final rule amending its regulation and policy governing the use of interest-rate futures. Institutions affected by the change must be insured by the Federal Savings and Loan Insurance Corporation. The amendments became effective July 10, 1981.

Under the amendments, insured Savings and Loan institutions ("S&Ls") are permitted to engage in futures transactions which will reduce their interest rate exposure due to fluctuations. Among other procedures S&Ls which are engaged in mortgage writings are permitted to establish long futures positions against their forward commitments to sell mortgages not yet initiated. These "long position hedges", however, will be limited by an "asset rule" which prohibits long positions for "spreading" techniques. S&Ls are now permitted to utilize financial futures contracts which are approved by the Commodity Futures Trading Commission and which have as the underlying commodity a security in which the S&L is as something confined to pits of hollering commodities traders bidding and dickering over the price of agricultural products yet to be grown is gone forever. Sophistication in the uses and strategies of forward and futures trading has increased and any bank that has not yet, or will not soon, acquaint itself with them will find itself rapidly lagging behind its more innovative competitors.

The financial futures area is no longer a frontier of banking or investment. It is a necessary adjunct to those activities in times such as these of volatile fluctuations in interest rate levels. Recognizing this, the federal banking agencies, CFTC, HUD and the SEC have begun responding to the need to regulate these burgeoning markets, which will become even more essential and active in the future.

However, the response must be coupled with an objective, even handed evaluation of the proposed regulations' effects on the economic factors of the marketplace, the utilization of the particular instrument being regulated, the effect on the user/investor of the marketplace and, of course, the complexities and costs associated with complying with the promulgated rules and regulations. To a significant extent potential users/investors of the marketplace must also become aware of and learn the proper and safe way of utilizing the futures and forward markets to their benefit. The user/investor should play an increasingly active role in assisting the various governmental agencies in formalizing an acceptable regulatory framework within which the system can safely and efficiently function.

Financial futures trading is not an activity that a bank should engage in without a great deal of prior thought and preparation. Futures trading, however, can be an effective tool for reducing the bank's financial vulnerability in times of economic instability and fluctuating interest rates. Quality services, trained personnel, controls and monitoring systems may prevent and/or deter to a significant extent, internal illegalities and errors, which may otherwise haunt a poorly structured venture into institutional financial futures trading.

---

authorized to invest and/or trade. Example of such securities are CD's, Treasury Bills, Treasury Notes, and GNMA's. Further, the new rules permit S&Ls to defer and amortize the profits or losses from futures positions over the expected life of the corresponding cash assets and liabilities. The overall impact of these changes are similar in nature to those affecting federally chartered banks. 12 C.F.R. §§ 545, 563, 571 (1981). *See generally*, Little, *The Two Edged Sword: Using Financial Futures for Risk Aversion or Risk Taking*, PENSIONS AND INVESTMENTS (August 13, 1979).

Washington and Lee Law Review

Member of the National Conference of Law Reviews

Volume XXXVIII | Summer 1981 | Number 3

Editor-in-Chief

STEVEN M. JOHNSON

Lead Articles Editors

W. JEFFERY EDWARDS
WALTER D. KELLEY, JR.

Managing Editor

HENRY DARNELL LEWIS

Research Editor

SAMUEL A. FLAX

Executive Editors

JEFFREY H. GRAY
NICHOLAS H. HANTZES
CAROLYN R. SAFFOLD-HEYWARD
MARK A. WILLIAMS

Note & Comment Editors

SUZANNE M. BARNETT
GORDON EDWARD BILLHEIMER, JR.
ALAN L. BUTTON
ELIZABETH P. DEVINE
KATHLEEN MARIE FENTON
REBECCA D. GRAVES
CHARLES JUSTER
ROBERT G. MCLUSKY
JAMES S. MCNIDER, III
THOMAS MCN. MILLHISER
G. SCOTT RAYSON

Staff

BEVIN R. ALEXANDER, JR.
SAMUEL N. ALLEN, III
LARRY A. BARDEN
EDWARD J. BEDFORD
I. SCOTT BIELER
SARA ANNE BURFORD
MARK EDWARD CAVANAGH
DOUGLAS J. CHUMBLEY
DANA S. CONNELL
ROBERT M. COUCH
KURT J. FISCHER
PAUL V. GERLACH
RICHARD J. KAHN
BROOKS D. KUBIK
W. IAN LAIRD
JAMES B. MCLAREN, JR.
A. KIRKLAND MOLLOY
JEFFREY C. PALKOVITZ
JOHN KENT PEARSON
JAMES REESE SHOEMAKER
PATRICIA ELIZABETH SINSKEY
SALLY FITE STANFIELD
JULIA G. THIGPEN
LIZANNE THOMAS
GLENN S. THOMAS
KENNETH B. TILLOU
MICHAEL LEE UNTI
PHIL N. WALKER
CAROLINE WANNAMAKER
RAND DAVID WEINBERG

Faculty Advisor
ROGER D. GROOT

FACULTY—SCHOOL OF LAW

ROBERT E.R. HUNTLEY, A.B., LL.B., LL.M.
President of the University and Professor of Law
ROY L. STEINHEIMER, JR., A.B., J.D.
Dean and Professor of Law
CHARLES VAILL LAUGHLIN, A.B., LL.B., LL.M., S.J.D.
Professor Emeritus
EDWARD O. HENNEMAN, B.A., J.D.
Assistant Dean and Assistant Professor of Law
ROGER D. GROOT, B.A., J.D.
Professor of Law
FREDERIC L. KIRGIS, JR., B.A., LL.B.
Professor of Law and Director of the Frances Lewis Law Center
LEWIS H. LARUE, A.B., LL.B.
Professor of Law
ANDREW W. MCTHENIA, JR., A.B., M.A., LL.B.
Professor of Law
J. TIMOTHY PHILIPPS, B.S., J.D., LL.M.
Professor of Law
WILFRED J. RITZ, A.B., LL.B., LL.M., S.J.D.
Professor of Law
THOMAS L. SHAFFER, B.A., J.D.
Professor of Law
JAMES W.H. STEWART, B.S., LL.B., LL.M.
Professor of Law
JOSEPH E. ULRICH, A.B., LL.B.
Professor of Law
RICHARD B. TYLER, B.S., M.S.E., J.D.
Visiting Professor of Law
DENIS J. BRION, B.S., J.D.
Associate Professor of Law
MARK H. GRUNEWALD, B.A., J.D.
Associate Professor of Law
JAMES M. PHEMISTER, B.S., J.D.
Associate Professor of Law
SAMUEL W. CALHOUN, B.A., J.D.
Assistant Professor of Law
WILLIAM S. GEIMER, B.S., J.D.
Assistant Professor of Law
STEVEN H. HOBBS, B.A., J.D.
Assistant Professor of Law
CATHERINE M.A. MCCAULIFF, A.B., M.A., PH.D., J.D.
Assistant Professor of Law
SAMUEL E. STUMPF, JR., B.A., J.D.
Assistant Professor of Law
SARAH K. WIANT, B.A., M.L.S., J.D.
Law Librarian and Assistant Professor of Law
RUDOLPH BUMGARDNER, III, A.B., LL.B.
Adjunct Professor of Law
ROBERT M. CAMPBELL, A.B., LL.B.
Adjunct Professor of Law
WILLIAM W. SWEENEY, A.B., LL.B.
Adjunct Professor of Law
JAMES C. TURK, B.A., LL.B.
Adjunct Professor of Law
ROBERT C. WOOD, III, B.A., LL.B.
Adjunct Professor of Law
HENRY L. WOODWARD, B.A., LL.B.
Adjunct Professor of Law
ROSS D. YOUNG, JR., LL.B.
Adjunct Professor of Law
CURTIS R. REITZ, A.B., LL.B.
Frances Lewis Scholar in Residence