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Preface

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PREFACE

PHILIP MCBRIDE JOHNSON*

Commodities regulation, like the commodity industry, is a booming area. Futures volume has tripled in the past five years and, with it, the number of firms and individuals needing federal licenses and operating under a duty to comply on a day-to-day basis with federal requirements has increased substantially. During the past five years, the number of registered commodity salesmen ("associated persons") has grown 60%, from 25,500 to over 40,000 people. The number of commodity pool operators is up 62%, and the number of commodity trading advisors has increased 87%. It stands to reason that the Commodity Futures Trading Commission (CFTC) along with the commodity industry and its lawyers, have more work to do.

When I first became acquainted with the futures business nearly 20 years ago, perhaps a score of attorneys nationwide had a substantial practice in the commodities area of law. All of the pertinent laws and regulations applicable to futures trading fit neatly into a small pamphlet. The key court decisions were relatively few, and the litigation workload was light. It was rare, for instance, for individuals to file private damage actions under the Commodity Exchange Act.

All of that has changed radically. Hundreds of attorneys now practice regularly in the commodities field. One hundred fourteen lawyers work at the CFTC alone. The Commodity Exchange Act and its regulations have expanded from pamphlet size to multivolume books. The pertinent judicial decisions now number in the thousands, and a large body of academic and professional literature on commodities law has also evolved.

Depending upon one's views about lawyers and government regulation, these developments could be either praised or condemned. Nevertheless, they are an inescapable reality. Perhaps the most intriguing question today regarding commodities law is how the government and

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the industry will interact given the dramatic expansion of both the law and the volume of business.

One scenario would be constant conflict between the CFTC and the industry, as the government flexes its legal muscles and the industry uses its economic power in a nonstop effort by each to impose its will upon the other. A second scenario would be a joint and cooperative effort by the CFTC and the industry to achieve compatible goals. The latter scenario is more likely to occur, although there will be inevitable times of strain and disharmony.

The CFTC and the commodity industry have substantial interests in common. Highest on the list is protecting the public from abusive practices or, put in business terms, maintaining public confidence in the futures markets. No one is *compelled* to trade futures, after all, and suspect markets will not attract business the way honest markets will. Long before the earliest federal regulation of the industry, the commodity exchanges recognized the fact that suspect markets fail to attract business and adopted formal, elaborate systems of self-regulation. Industry self-regulation receives its share of criticism, of course, and does not always work as well as one might hope. The fact that self-regulation exists, (and has for over a century), however, demonstrates that the CFTC and the industry have a very important common interest in maintaining public confidence in the commodities market.

Since both the CFTC and the commodity industry share the same public protection goal, the next question concerns the best method for allocating responsibility to achieve that aim. How much should the CFTC do to regulate the industry, and what reliance should the CFTC place on industry self-regulation? Some argue that the CFTC should recede into the background (or even disappear), leaving day-to-day policing of the market to the industry. Others claim that self-regulation is inherently untrustworthy and even minor reliance on it is a mistake. Most observers, however, take a middle ground, saying "yes" to a shared role, but disagreeing as to the proper division of functions between the CFTC and the industry. Most of the important decisions in the next few years likely will focus on demarcation lines rather than "all or nothing" propositions.

In the budgetary climate of Washington today, there is little risk that the CFTC will mushroom into a giant agency. Congress simply is not in any mood to go on a spending spree for the CFTC or any other federal program. Thus, the CFTC has very practical reasons for encouraging broader and more effective industry self-regulation. At the same time, the futures markets are strong, healthy and generally prosperous. Through a wise diversification in the types of futures contracts offered, most markets have decreased their vulnerability to downturns in a particular economic sector. Simply put, the industry never has been in better condition to assume more self-regulatory responsibility.

The principal vehicles for enhancing self-regulation are the commodity

exchanges, the brokerage houses, and the fledgling National Futures Association (NFA). The NFA, in particular, holds promise in this area. Yet, it will not be enough for the industry simply to *want* more self-regulatory responsibility. The public must believe that increased self-regulation in the commodities market is a good development, especially if the CFTC transfers its functions to the industry. A great deal more work needs to be done here.

The principal obstacle to public acceptance of self-regulation is the gnawing and widespread suspicion that making money (or avoiding losses) motivates businesspeople more than performing a selfless act of public service. That suspicion is probably accurate, if only instincts are examined. The existence of laws, the CFTC, and the enlightened self-interest within the industry itself, however, have meant that knee-jerk impulses to maximize profits or minimize losses seldom prevail when businesspeople make a choice between private and public interests.

Even so, self-interest sometimes overwhelms ethical duties, as many a biblical story recounts. Often it is human nature not to trust human nature. Those who aspire to regulate themselves need to understand that consideration. Unfortunately, self-regulators historically have said "trust us" instead of preparing to *prove* that their actions and decisions are truly impartial.

Self-regulators in the commodities market need a systematic way to achieve demonstrable impartiality in the decisionmaking process. The key word here is "demonstrable." The first step is to identify those situations in which self-interest plays a significant role. In the case of commodity exchanges, one example is a market condition that needs immediate attention. If the decisionmakers participate in that market, it is critically important that the decisionmakers document why they acted or withheld action and, if they took remedial steps, why they did not intend those measures to benefit the decisionmakers personally. The decisionmakers should record this information *before* the market registers a reaction to that decision. After-the-fact justifications are never as credible as proof of impartiality developed in advance.

Instances where a person's own interest in the market demands full recusal will exist. In other cases, a person's interest may be sufficiently minor or tangential so that disclosure to the other decisionmakers suffices, especially if the disinterested members of the panel have the authority to decide whether or not an interested person should participate. These are difficult judgments to make in many circumstances and yet they must be made. If the process is systematized and recorded, later challenges can be more easily answered.

The CFTC is actively considering this issue. It has no real choice in the matter. If the commodity industry wants the public to gain enough confidence to support a greater role for self-regulation, and if the CFTC wants to rely more heavily on self-regulation in the future, the "trust us" approach must give way to a means of proving the integrity of self-

regulation on a continuous basis. Once achieved, the relationship between the CFTC and the industry in the years ahead can mature into one of greater federal oversight and expanded private self-policing.