SCAMS, SCOUNDRELS, AND SCAPEGOATS: A TAXONOMY OF CEA REGULATION OVER DERIVATIVE INSTRUMENTS

Wendy L. Gramm

is professor of economics and public administration at the University of Texas at Arlington. She was chairman of the Commodity Futures Trading Commission from 1988 to 1993.

Gerald D. Gay

is professor of finance at Georgia State University. He was chief economist of the CFTC from 1990 to 1993.

We present a framework for understanding the current regulatory scheme for derivative instruments as governed by the Commodity Exchange Act (CEA). Our purpose is threefold: 1) to clarify for financial economists and practitioners the existing regulatory landscape for commodity instruments and to explore its influence on innovation; 2) to explain how this framework evolved and discuss some problems it has created; and 3) to identify policy issues for which research on optimal regulatory structure can provide important contributions.

We begin by exploring four factors that are largely responsible for the existing regulatory scheme: the exchange trading requirement, a virtually all-inclusive definition of a commodity, the exclusivity clause, and the checkered history of options trading. We then provide some war stories, including background on the CFTC/SEC jurisdictional disputes and the futures versus forwards controversy that has affected the off-exchange market.

We next describe the current commodity instrument regulation. Two product strands are presented: those having futures-like characteristics and those that are more option-like. Descriptions and criteria are presented for instances where instruments may be excluded or exempted from certain or all CEA regulations. We conclude by identifying some policy implications raised by our analysis that we believe warrant further investigation.

[The stock index futures contract] application...should be rejected. Our belief stems from the enormous potential of this proposed contract for purely speculative abuse. In addition, the purported economic purpose it is alleged to serve is yet unproven and, in any event, it is likely to be of limited utility.

—Regulatory Wisdom

1
As students of financial markets are aware, much of the phenomenal growth in financial innovation over the last two decades has occurred in the derivatives arena. Paralleling this success has been an equally impressive amount of regulatory attention. While some of this attention has focused on economic issues such as financial and market integrity and concerns over customer protection, we suspect that much of the interest stems from bureaucratic incentives and simple anti-competitive behavior mixed with a misunderstanding of derivatives.

For example, rather than seeing an honest debate over the appropriate regulation for these markets, we observe instead government agencies attempting to expand their jurisdiction by trying to expropriate other agencies’ turf. Exchanges and established firms call for “level playing fields,” which can be a euphemism for banning, regulating, or otherwise imposing costs on the innovator before the potential competitor becomes too successful. Members of Congress purport to have identified newfound “black holes” in the regulatory universe. And the media never seem to miss an opportunity to point to an “underregulated” derivatives market as the culprit behind any market crisis or price blip.

As the saying goes, however, “the more things change, the more they stay the same.” The pattern of resistance to a new derivative product when it has become successful or is viewed as a potential competitor to established products, often followed by blame for a market event and calls for more regulation, is not unique to stock index futures and swaps. The pattern has repeated itself over the last century.

One result has been the patchwork of regulations currently governing derivative instruments. This patchwork is not innocuous. The financial engineer is often foiled when an innovative new instrument does not fit neatly into a specific part of the regulatory structure or when counsel advises that legal uncertainty will likely stem any demand for the product. Regulatory approval (often in the form of no-action letters) may be sought, wasting resources and delaying development and sale of the product.\(^2\) In many instances, the product may not be developed in the U.S. but may be produced and sold overseas, depriving U.S. industry and firms of use of such products.

Economists have often been discouraged from participating in debates involving derivatives regulation because the issues lack clarity and appear to be simply legal arguments having little economic content. Yet, as several authors have pointed out, regulation is perhaps the driving engine behind financial innovation and therefore deserves serious scrutiny.\(^3\)

Until more economists join the debate, the important policy issues of the appropriate regulation of derivatives or regulatory structure of financial markets will remain as they have for decades — debate over the meaning of words, and dominated by scapegoatism and anti-competitive behavior, rather than debate over what is truly appropriate regulation.

In this article we present a framework for understanding the current regulatory scheme for derivative instruments as governed by the Commodity Exchange Act (CEA).\(^4\) Our purpose is threefold: 1) to give financial economists and practitioners a better understanding of both the existing regulatory landscape for commodity instruments and the way it influences innovation; 2) to provide background into the way this framework evolved and some problems that it has created; and 3) to identify policy issues for which researchers can provide important contributions as to the optimal regulatory structure for these markets.

We first explore four factors that are largely responsible for the existing regulatory scheme: 1) the exchange trading requirement of the CEA, which provides that all futures trading be conducted on an exchange designated by the CFTC; 2) a virtually all-inclusive definition of what is a commodity; 3) the exclusivity clause of the CEA that gives the CFTC statutory jurisdiction over all commodity futures and options; and 4) the checkered history of options trading, which has led to its heavy regulation. We then discuss some of the more interesting battles that have been waged, including the CFTC/SEC jurisdictional disputes and the futures versus forwards controversy, which has substantially affected the off-exchange market.

In our description of the current lay of the land with respect to commodity instrument regulation, we present two product strands: those having futures-like characteristics and those that are more option-like. Descriptions and criteria are presented for instances where instruments may be excluded or exempted from certain or all CEA regulations. We conclude by
identifying some policy implications raised by our analysis that we believe warrant further investigation.\textsuperscript{5}

I. LOOKING BACK: HOW DID WE EVER GET HERE?

**Federal Regulation over Futures**

Calls for federal regulation of commodity futures first began in the last half of the 1800s, following repeated public outcry, primarily expressed by the agricultural community, over excessive commodity speculation and the operations of bucket shops that offered both futures and options contracts. Farmers and their legislators complained whenever they did not understand or did not like a decline in agricultural prices. They often blamed futures, and called for the elimination of speculators at the futures exchanges, who they believed drove prices down unfairly. While this argument often held little merit, the calls for regulation were joined by others with a more legitimate claim — to eliminate the bucket shops that defrauded people.

**SCAMS AND SCOUNDRELS: BUCKET SHOPS.**

The typical bucket shop sold futures and options contracts based on price quotes generated by the futures exchanges. They did not execute orders through any exchange, but took positions opposite the customer. Because the contracts traded at bucket shops did not entail delivery and did not provide a price discovery function, many concluded that these operations were mere gambling houses.

Their profitability depended on commissions from having a balanced book of customers on both sides of the market; or, if the operation was on one side of the market, profits also were realized when prices moved in its favor. In the event of an unfavorable market move (a favorable one for their customers), bucket shops would frequently close down and set up business elsewhere. In many instances the bucket shops were alleged to have misrepresented their product to the extent that many customers believed they were getting a contract that was executed on an exchange.

The problems and complaints generated by bucket shops provided impetus for reform. The exchanges were leaders in advocating legislative restrictions against the bucket shops because of several problems they posed for an exchange.\textsuperscript{6} First, they provided unwanted economic competition for order flow, especially because many customers of bucket shops believed their orders were being executed on an exchange. The bucket shops offered lower commissions, flexible contract sizes, longer trading hours, and fewer rules.

Second, the bucket shops “freerode” off the price quotations generated by the exchanges. Third, as many people could not differentiate between activities conducted on the bucket shops and on the exchanges, the exchanges suffered reputational damage. The exchanges thus supported the enforcement efforts of the states against the bucket shops, and took numerous actions to gain protection over their quotes, culminating in a 1905 Supreme Court decision that recognized the exchanges’ property rights to their quotes.\textsuperscript{7}

**EARLY FEDERAL REGULATION OF EXCHANGES: THE NOOSE SLIPS ON.** Prior to 1920 the exchanges were very successful in thwarting the imposition of federal regulation. It is reported that up to this time over 160 bills to restrain or eliminate futures trading were introduced in Congress, often by a Congressman attempting to appease a group of agricultural constituents. The closest to gaining passage was the Hatch Bill, which was introduced during the first session of the Fifty-Second Congress (1891-1892).

The Hatch Bill proposed to levy a prohibitive tax on all futures contracts in a listed set of commodities including grains. The bill passed in the House and was later passed by the Senate, but with slight amendments. As the amended bill was reported out of conference, the House was required to approve it.

Meanwhile, opposition to the bill began to build, delaying the vote. With three days left in the session, Representative Hatch asked that the House rules be suspended and the bill brought up for a vote. Such a tactic was a gamble, because voting under a suspension of rules requires a two-thirds majority to win approval. The final vote was 172 to 124 in favor, short of the necessary two-thirds.

Around the turn of the century the exchanges made serious efforts to escape the growing pressure for regulation by, for example, adopting self-regulato-
ry rules to police member conduct, take disciplinary actions, and implement standards of grading, inspection, and weighing. Events following World War I, however, would eventually prove too strong to overcome.

The war gave rise to substantially higher farm output in order to meet the increased foreign demand. In 1917, as the war progressed, President Wilson created the Food Administration Grain Corporation to take over most grain marketing, and he appointed a committee to recommend a support price for wheat. With the establishment of a support price, the Chicago Board of Trade (CBT) halted wheat futures trading following the close on August 25, pursuant to a letter dated August 11, 1917, from Food Administrator Herbert Hoover.

Following the war, crop production remained very high. Price supports continued until June 1, 1920. Following their elimination, the CBT resumed trading in wheat futures on July 15. Shortly thereafter, commodity prices experienced extremely large price declines. A tremendous populist outcry ensued, especially among Western farmers centered around Kansas.

Senator Capper and Congressman Tincher, both from Kansas, launched investigations into the price collapse, and subsequently conducted hearings in an attempt to introduce new legislation that would regulate grain futures trading. Around the same time, a Senate resolution was passed in October, requesting that the Federal Trade Commission (FTC) also begin an investigation. Before it had even initiated its formal investigation, the FTC in a December 20 report to President Wilson stated:

> While evidence is not available that future trading is responsible for the decline in wheat prices, it does not appear that future trading in wheat, as at present operating, is of indisputable service to the grain trade (New York Times, December 21, 1920, p. 28).

The report went on to state:

> It appears that there is a large volume of future trading that is mere gambling and involves a great economic waste. The remedy for this lies in Congressional action to prevent trading which is essentially gambling (Ibid.).

The result of these events was the Future Trading Act of 1921, which included a 20 cents per bushel tax on grain futures transactions other than those made by or through a member of a designated contract market (an exchange). After the Supreme Court found the futures tax unconstitutional, as an invalid exercise of taxing power, Congress passed a very similar bill called the Grain Futures Act of 1922 premised on the commerce clause of the constitution. The statute included, among other things, an exchange trading requirement such that all futures trading be conducted on exchanges designated by the Secretary of Agriculture as “contract markets.”

**THE EXCHANGE TRADING REQUIREMENT.**
The exchange trading requirement emanating from the 1921 and 1922 legislation forbids dealings in grain futures trading unless “the seller is at the time of the making of such contract the owner of the actual physical property covered thereby, or is the grower thereof,” or “where such contract is made by or through a member of a board of trade which has been designated by the Secretary of Agriculture as a ‘contract market’.” Factors specified for an exchange to be designated as a contract market include that it keep records of transactions, provide for the prevention of false or misleading information that would affect prices, and, most importantly, that it seek to prevent the manipulation of prices or cornering of any grain market.

While today the exchange trading requirement is widely understood to ban off-exchange futures, this may have been an unintentional result. One view of Congress’s original concern in passing legislation was that it was intended to address the abuses of bucket shops and the bucketing of customer orders, not to ban all off-exchange futures (see Johnson and Hazen [1989]). An alternative view is that Congress intended to ban all futures trading of grain but carved out an exception to allow trading of grain futures on the CBT (see Schroeder [1986]).

**A CARVEOUT FOR CASH FORWARD CONTRACTS.** The 1922 Grain Futures Act provided an important exclusion from federal regulation for cash forward contracts. To this date, forward contracts or contracts of sale of a cash commodity for deferred
shipment or delivery are not to be regarded as futures. Congress did not wish to affect or regulate the business activities of farmers in buying and selling their grain.

Even Senator Capper, one of the sponsors of the original legislation and a vocal critic of the exchanges, recognized the importance of the exclusion in his statement that the legislation did not concern itself at all with the sale or purchase of actual grain, either for present or future delivery. The entire business of buying and selling the actual grain, sometimes called "cash" or "spot" business, is expressly excluded. It deals only with the "future" or "pit" transaction, in which the transfer of actual grain is not contemplated.

SUBSEQUENT FEDERAL REGULATION: THE NOOSE TIGHTENS. Subsequent pieces of federal legislation include the 1936 amendments to the act, at which time it was renamed the Commodity Exchange Act (CEA). A review of the legislative history of this and subsequent amendments up until 1974 indicates that a principal objective was to bring an increasing number of agricultural commodities under federal regulation. Often, the commodities were added in response to episodes of public agitation over "excessive" price volatility or corners. Exhibit 1 shows when various commodities were brought under federal regulation.

EXCLUSIVITY AND AN ALL-INCLUSIVE COMMODITY DEFINITION: THE KNOT IS SECURED. In 1974 Congress passed amendments to the CEA authorizing the creation of the CFTC as an independent agency, and giving it exclusive regulatory jurisdiction over all commodity futures and option trading. Also, breaking the traditional pattern of bringing commodities under the regulatory umbrella on a piecemeal basis, Congress simply expanded the list to include essentially everything. In other words, the term "commodity" was so defined that it captured all previously enumerated commodities (except onions), all other goods and articles, and all services, rights, and interests in which contracts for future delivery are now or will be in the future dealt in.

The exchange trading requirement, that all futures activity be conducted on or subject to the rules of a board of trade so designated by the CFTC, became Section 4(a) of the CEA. This exchange trading requirement, the expansion of the definition of a commodity to include virtually anything, and the exclusivity clause, which designates the CFTC as the exclusive federal regulator of commodity futures and options, have created uncertainty, confusion, and much misunderstanding among market participants and regulators as well. The exclusivity clause has been blamed for creating a "monopoly" for futures exchanges and has been at the center of much of the jurisdictional debate between the SEC and the CFTC. In fact, the other two elements have probably contributed more to legal uncertainty than the exclusivity clause.

The expansion of the definition of a commodity to include virtually anything, when coupled with the exchange trading requirement, suddenly made all off-exchange futures illegal. In the past, only the specific, "enumerated" commodities (commodities specifically mentioned or enumerated in the CEA) were subject to federal regulation and had to be traded on an exchange. Thus, only the off-exchange trading of those enumerated commodities was illegal. When
the definition of commodity was expanded, making the off-exchange trading of all futures illegal, the impact was far greater than expected.

At the last minute, the Department of the Treasury inserted the Treasury Amendment to exclude interbank trading in foreign exchange, government securities, and certain other listed instruments from the CEA. The amendment has been the source of private litigation and some disagreement between the Treasury Department and the CFTC over the years. Some argue that the "plain meaning" of the statute excludes all foreign exchange transactions, regardless of the nature of the participant, unless the transactions are conducted on a futures exchange. Others contend that the exclusion is limited to large and sophisticated investors and not to members of the general public.

The exchange trading requirement coupled with the expansive definition of a commodity has been the source of substantial legal uncertainty, especially as the risk management revolution has made over-the-counter (OTC) tailored products more popular. If a new OTC product were determined to be a future, then it would be illegal. If a party wished to get out of a contract that had become unprofitable, it could just claim that the contract was a futures transaction and thus illegal.

The exclusivity clause, added in 1974, states that futures were the exclusive jurisdiction of the CFTC — meaning that financial futures could not be regulated by the SEC or any other federal regulator, even if the underlying product were a security. The exclusivity clause by itself is not unusual. The SEC, for example, is the sole federal regulator of many transactions.

The real difficulty with the exclusivity clause is that the securities industry and the SEC did not wish to view a derivative product, where the underlying product was a security, as outside their domain. Thus, the exclusivity clause became a target for jurisdictional battles between the SEC and the CFTC as the SEC sought to regulate as a security those derivative products where the underlying instrument is a security.

Thus, the exclusivity clause, the broad definition of a commodity, and the exchange trading requirement laid the groundwork for the ensuing struggles over what is and what is not a futures and who should regulate it. These features of the CEA play a key role in the difficulties and legal uncertainty that have accompanied the development of derivative instruments.

Federal Regulation over Options

The heavy regulation of commodity options (or "privileges," as they were once termed) stems from a view that they are merely gambling instruments because they did not entail actual delivery and instead were cash-settled on the basis of "differences." In addition, options have been more susceptible to fraud than futures because premiums are paid up front. Finally, there have been fewer defenders of exchange-traded options.

PRIVILEGE TRADING. Beginning during the latter 1800s, the exchanges (notably the CBT) made numerous attempts to prevent members from trading in privileges, which at the time had not become legitimate exchange contracts. Courts cited an Illinois statute to rule that trading in puts and calls was illegal. But the exchanges' attempts were not vigorously enforced. Exchange members believed that these instruments provided needed hedging vehicles and helped stabilize futures prices.

An apparent intent of the exchanges was to keep the more flagrantly open trading of privileges off the trading floor during regular trading hours, and instead to confine it to outside the building, on the curb. The exchanges took the position that members solely bore the financial risk of these kinds of activities, and that the exchanges would not intercede in the event of a member dispute.

During the 1890s and early 1900s the exchanges began taking more serious steps toward enforcing rules against privilege trading by making the offense punishable by suspension or expulsion. Yet trading continued among members through such means as the execution of orders on other exchanges that did permit option trading. Around 1906 the CBT attempted to capture some of the business by permitting a modified form of privilege trading called "indemnity" trading, which was basically options exercisable into futures contracts and thus viewed as legally permissible.

EARLY FEDERAL REGULATION OF OPTIONS: A SCAPEGOAT IS FOUND. The 1921 Future Trading Act effectively ended privilege trading through the imposition of a 20 cents per bushel tax.
While, as discussed earlier, the tax on futures was ruled unconstitutional almost immediately, the tax on privilege trading was not found unconstitutional until 1926 (Trusler v. Crooks, 269 U.S. 475 [1926]). The following day, the CBT amended its rules to permit privilege trading to resume. Other exchanges followed.

Trading in privileges continued at the CBT until a large collapse in grain prices occurred on July 19 and 20, 1933, at which time their trading was suspended by exchange action. It was reported that the price decline was the most sensational collapse in futures prices ever to have occurred on the CBT.

At a Department of Agriculture meeting regarding the large price decline, a committee representing the exchanges announced that "the elimination by the exchanges of trading in indemnities [had] removed one of the prime causes of excessive price movements." Furthermore, the representatives stated their intention to recommend to the exchanges the permanent elimination of privilege trading as a reform measure.

Subsequently, the Code of Fair Competition for Grain Exchanges under the National Industrial Recovery Act, approved by President Roosevelt on March 20, 1934, required that exchanges prohibit all option trading. While later invalidated by the Supreme Court, the prohibition was resurrected with the passage of the CEA amendments of 1936 (but did not apply to options trading on commodities not named in the CEA, the "non-enumerated" commodities).

Thus, the ban on options trading appears to have come into existence without factual evidence that options trading indeed had contributed to price instability. Because of their smaller volume or the belief that some action had to be taken to ward off even worse federal initiatives (e.g., a ban on futures trading or more regulation), it appears that the options ban occurred as a result of their being offered up as a sacrifice by the exchanges to preserve futures trading (see Stassen [1982]).

OPTION REGULATION UNDER THE CFTC: MORE SCOUNDRELS AND SCAMS. The prohibition against options trading in the enumerated (or regulated) commodities was maintained up to and through the time of the passage of the 1974 CEA amend-
ments. During consideration of the 1974 amendments, however, Congress used the opportunity to review the regulatory scheme for options. Also, around this time there were a number of commodity option scandals, the most notorious being the Goldstein-Samuelson episode.

In 1971 the firm Goldstein, Samuelson Inc. began offering options on commodities not enumerated under the CEA. While the option positions were purported to be covered with futures positions, the vast majority remained naked, and the enterprise operated as a "Ponzi" scheme, with payments to earlier investors made from the resources of subsequent investors. Eventually, the firm failed, with customer losses estimated to be over $70 million.

The 1974 CEA amendments brought options trading on all commodities under federal regulation. The CFTC was granted authority to permit options trading, but only in the pre-1974 non-enumerated commodities.

The 1974 amendments giving the CFTC exclusive jurisdiction effectively preempted the jurisdiction of both the states and the SEC. The preemption of the states' authority resulted in the removal of a large enforcement body and placed a substantial burden on the CFTC's ability to monitor abuses. The result was a proliferation of firms offering off-exchange options, with many enforcement actions brought against those firms engaged in fraudulent activity. The complaints typically were against the boiler-room type of operations engaged in fraudulent sales practices.

In addition to enforcement action, the CFTC's regulatory initiatives in addressing options sales fraud included the passage of anti-fraud rules and the requirement that options dealers register as FCMs and comply with capital requirements. Many firms simply ignored the registration requirements, while others used their registration status with the CFTC as a marketing device to "legitimize" their activities.

By 1977 the CFTC found itself again having to contend with a surge of complaints regarding option abuses. Many of these involved firms purported to be selling "London" options — that is, options traded on exchanges in London, England. In practice, the firms often were bucketing customer orders.

The most celebrated of these cases involved the
firm Lloyd, Carr & Co. After numerous unsuccessful attempts to close the firm’s operations, it was discovered that Mr. Carr was really Alan Abrahams, an escaped felon from a New Jersey prison. Abrahams was eventually arrested and returned to prison, while the company was enjoined and placed in receivership. Estimates of customer losses were placed at $50 million.

In 1978, as a result of the overwhelming number of complaints involving options and the CFTC's limited enforcement resources, the CFTC threw in the towel, and banned all options trading with the exception of specified dealer options in metals. The ban lasted until 1981 when the CFTC initiated an options pilot program, which permitted a limited number of options on futures for non-enumerated commodities to be traded on designated exchanges under an elaborate set of regulatory controls to limit abuses. Among these were special rules governing disclosure, margining, filing of promotional materials and customer complaints, establishment of special supervision procedures, and audits of firms' sales practices.

The 1982 amendments to the CEA significantly restored the states' enforcement abilities against option abuses. Section 12(e) of the CEA created an "open season" provision, which provided that the CFTC's exclusive jurisdiction would not prohibit the states from proceeding against persons not complying with the CEA's regulatory requirements. Finally, another significant development regarding the 1982 amendments was the removal of the ban on options on futures for the enumerated commodities provided that the CFTC establish a pilot program for their trading.

**War Stories**

**JURISDICTIONAL STRUGGLES WITH THE SEC.** As noted earlier, Congress in 1974 gave the CFTC exclusive federal jurisdiction over all futures trading. The result has not sat well with other regulators, notably the SEC.

The first skirmish soon followed, with the CBT's launching in 1975 of the GNMA futures contract. On the day before trading commenced, the SEC sent a warning letter to the CBT suggesting that the SEC might view such action as illegal, given its statutory jurisdiction over securities. Several meetings were held and correspondence exchanged among the SEC, CFTC, and CBT, and the SEC eventually took no formal action. Similar concern was raised by the SEC shortly thereafter over the Chicago Mercantile Exchange's (CME) launching of Treasury bill futures.

In 1978 the Kansas City Board of Trade (KCBT) submitted the first application to trade stock index futures. In response to a request to comment on the application, the SEC responded to the CFTC that the contract had no proven economic purpose, was likely to be of limited utility, and should be rejected.

Also during 1978, in the midst of the CFTC's first reauthorization process, the SEC moved to expand its jurisdiction by seeking oversight of futures on securities, but Congress rejected this attempt. At this time the Treasury Department sought to dilute the CFTC's jurisdiction over futures on government securities by acquiring rights to veto any new such contract, as well as to suspend trading or revoke the designation of an approved contract. Congress rejected all these proposals, but did amend the law to require the CFTC to afford the Treasury Department and the Board of Governors of the Federal Reserve System forty-five days to comment on any new futures contract on a government security prior to CFTC approval.

The next struggle ensued in 1981, when the SEC approved the Chicago Board Options Exchange (CBOE) proposal to launch options on GNMA certificates. The CBT filed suit, arguing that the SEC lacked jurisdiction to approve the contracts because the certificates were commodities under the CEA and thus subject to the CFTC's exclusive jurisdiction. A ruling by the Seventh Circuit Court of Appeals supported the CBT's position. While the case was pending, however, an agreement was reached between the chairmen of the CFTC and the SEC that eventually granted the SEC jurisdiction over such options.

This agreement, reached on December 7, 1981, followed an attempt by the two agency chairmen to resolve the jurisdictional conflict between the two agencies. The result was the Shad-Johnson Accord ("Accord") which was enacted into law as part of the Futures Trading Act of 1982 amendments to the CEA.

The Accord divided the regulatory landscape, giving the SEC jurisdiction over options on securities
and the CFTC jurisdiction over futures and options on futures on "exempt" securities\textsuperscript{16} and indexes of securities. Also, futures on individual securities were prohibited.

Finally, on any stock index futures submission subsequent to December 9, 1982, the SEC is given veto authority; within forty-five days following the close of the public comment period, the SEC is to determine whether a proposed contract meets the minimum requirements of the Accord provisions; that is, the contract is cash-settled, not readily susceptible to manipulation, and reflects the market for all securities, or a substantial segment thereof.

The Accord brought several years of peace to the jurisdictional battles until the October 1987 market crisis. In the many hearings and reports that followed, proposals ranged from the shifting of stock index futures margin oversight to the Federal Reserve to the creation of a single financial regulator. These issues were at the center of much of the debate during the CFTC's reauthorization hearings beginning in 1989.

In April 1989 the SEC issued an order permitting the American Stock Exchange, the CBOE, and the Philadelphia Stock Exchange to trade instruments known as index participations ("IPs"). IPs were contracts to purchase or sell the value of an index based on a basket of securities, instruments that many argued were futures contracts that should be traded on a futures exchange. The CME and the CBT filed suit against the SEC and the securities exchanges, arguing that IPs were futures contracts and thus subject to the exclusive jurisdiction of the CFTC.

On August 18, 1989, the Seventh Circuit Court of Appeals set aside the SEC's order of approval, which halted the trading of IPs. In characterizing the difficulty that the current regulatory scheme posed, Judge Frank Easterbrook wrote "we must decide whether tetrahedrons belong in square or round holes" (see \textit{Chicago Mercantile Exchange v. S.E.C.}, 883 F.2d 537 [7th Cir. 1989]).

One may wonder why there was so much controversy, because the securities exchanges could have sold these types of products legally on their futures subsidiaries. Alternatively, they could alter the product slightly (such as the TIPs product, which trades as a security on the Toronto Stock Exchange) to make it a real security and thus tradable on a securities exchange.

There are at least four reasons why the securities exchanges did not wish to alter their product: 1) to avoid the burdensome regulations of the Investment Company Act of 1940;\textsuperscript{17} 2) to benefit from the economies of using the much larger securities sales force to retail the futures product;\textsuperscript{18} 3) to continue to label the product a security to overcome customer fears of alleged greater risk of futures products, or to sidestep institutional and regulatory limitations on the purchase of futures by investment managers; and 4) to circumvent a restrictive covenant in a licensing agreement that gave a single futures exchange (the CME) the rights to trade a stock index futures using the S&P 500 name. The last two reasons are the most important reasons the securities exchanges wanted to be able to sell futures as securities, from our understanding of communications between relevant parties.

A RECIPE FOR LEGAL UNCERTAINTY. The exchange trading requirement coupled with the expansive definition of a commodity has posed significant difficulties for various commodity products in terms of legal uncertainty. Examples of three such markets affected include swaps, hybrids, and Brent oil contracts.

The cloud of legal uncertainty or risk cast over these markets comes from the potential for the CFTC or a court of law to determine that a transaction is indeed a futures contract, and thus illegal unless traded on a designated board of trade.\textsuperscript{19} This issue is complicated by the fact that the CEA provides no definition of a futures.\textsuperscript{20} The closest the CEA gets is its reference to a "contract of sale of a commodity for future delivery." The CEA does provide an exclusion for cash forward contracts when it goes on to say that the term "future delivery" ... "shall not include any sale of any cash commodity for deferred shipment or delivery."

The courts and the CFTC have attempted to provide guidance as to what constitutes a futures by frequent reference to the characteristics: 1) the instrument is for the purchase or sale of a commodity for future delivery; 2) the price or pricing formula is set when the contract is initiated; 3) the underlying purpose is to assume or shift price risk, rather than to transfer ownership of the actual commodity; and 4)
the contract may be fulfilled by offset or other buyback arrangements.21

A broad definition for futures can endanger many kinds of contracts not intended to be covered by the exchange trading requirement, including many OTC derivative contracts or many cash or forward transactions. This could give rise to legal uncertainty as the CFTC could bring an enforcement action and invalidate certain contracts. In addition, a counterparty facing an unfavorable market move could claim that a contract is null and void because it is an illegal off-exchange futures. The agency's enforcement arm, on the other hand, likes the broad definition so it can easily shut down boiler-room operations selling futures without having to show fraud by claiming they are illegal off-exchange futures.

The greatest area of legal uncertainty stems from forwards (and swaps) because they already share many characteristics of futures. Furthermore, because futures markets essentially developed from the forward market, it is not surprising that as new kinds of forward markets developed, they too might begin to behave like futures markets. Similar arguments could be applied to hybrid instruments or securities or depository instruments including commodity futures and/or option-like characteristics. Because the CFTC has exclusive jurisdiction over futures, it is argued that hybrids are, therefore, subject to the CEA. With this view of the world, in 1987 the CFTC undertook a series of actions that shook the swaps and hybrids markets.

First, the CFTC initiated an investigation of a major money center bank to determine whether the commodity swap contracts it offered were illegal off-exchange futures, causing much of the U.S. commodity swap business to move offshore. Second, the CFTC sought and obtained a permanent injunction against Wells Fargo Bank, preventing it from continuing its offering of a depository instrument with a return linked to the upside movement in the price of gold.

Third, the CFTC later that year issued an "advance notice of proposed rulemaking" that contemplated allowing swaps and hybrids, but only on highly restrictive terms. The proposed restrictions regarding hybrids were that the futures and option component be de minimis, and that it serve a commercial purpose and be entered into other than for speculative, hedging, or investment purposes. For swaps, the transaction would be restricted to commercial counterparties that are engaged in the commercial use of the underlying commodity and would not be entered into for speculative or investment purposes.

The restrictive rules were not proposed. Rather, the CFTC took actions on both swaps and hybrids that provided both much needed legal certainty and sufficient design flexibility for these markets to grow within the U.S.

A third example of the way legal uncertainty can seriously impair the operations of a forward market is the case of Transnor (Bermuda) Ltd. v. BP North America Petroleum (738 F. Supp. 1472 [S.D.N.Y. 1990]). In this instance, Transnor turned to the courts in an attempt to recover losses resulting from trades in the fifteen-day Brent crude oil forward market. After contracting to purchase two cargoes of oil, the firm refused to accept delivery after the market value of oil had fallen.

Transnor claimed that the defendants had conspired to cause a decline in crude oil prices in violation of the anti-trust laws under the Sherman Act. Also they claimed that the contracts were futures subject to the CEA, and that their prices were manipulated. In April 1990 the Southern District Court of New York ruled that the transactions were futures contracts based on an ex post analysis that a high percentage of the transactions did not result in delivery because of that market's extensive use of the clearing techniques of offset and bookout.

Many forward markets in addition to the Brent market were immediately affected by the legal risk created by the District Court decision. The ruling had the unintended effect of causing many market participants to believe that these contracts might be illegal off-exchange futures. The Brent market experienced a significant decline in liquidity as trading at first nearly came to a halt. A large number of European companies completely withdrew from trading in the U.S. or with U.S. counterparties. Trading resumed somewhat as some U.S. firms set up offshore operations.

The CFTC attempted to rectify the Court's decision, and in September 1990 issued an interpretation that the Brent contracts satisfied the forward contract exclusion because the transactions created specifi-
ic delivery obligations that imposed substantial economic risks of a commercial nature on the participants. The relevant issue was not the subjective intent as to delivery, but the need to negotiate a separate agreement in order to extinguish a delivery obligation. Trading volume in the Brent market recovered somewhat, but not to earlier levels.

For each of these three markets, as well as for other kinds of products, the CFTC, between 1988 and 1992, attempted to provide legal certainty by issuing rules, statutory interpretations, and policy statements. In addition, numerous no-action letters were issued in response to questions raised by market participants about a specific product. While these actions may assure affected parties that the Commission will not bring an enforcement action, some legal uncertainty remains with the risks of third party litigation and the possibility that members of a later Commission may have a different view.

The questions raised, especially about swaps and hybrids, IPs, and the Brent forward contracts, were debated at length between 1989 and 1992 during the CFTC’s reauthorization. Many proposals were discussed and rejected, including merging the agencies, giving stock index futures jurisdiction to the SEC, allowing futures to be regulated by the SEC, and defining futures and forwards.

Ultimately, in October 1992, the Futures Trading Practices Act was signed into law, leaving the basic framework of functional regulation intact, with the CFTC regulating futures and the SEC regulating securities (with the few exceptions specified by the Accord). But perhaps most important, amendments to the CEA gave the CFTC for the first time the authority to exempt any agreement, contract, or transaction from any or all provisions of the CEA, including the exchange trading requirement. This allows the CFTC to craft regulations that are appropriate for the situation at hand. The CFTC moved quickly in early 1993 to issue rules and an order exempting certain swaps, hybrids, and energy (forward) contracts from Commission regulations.

II. CURRENT LAY OF THE LAND

In this section we describe the current regulatory landscape for commodity instrument regulation. Two strands are presented: those products or instruments with futures-like characteristics and those that are option-like.

Regulation of Futures-Like Contracts

Exhibit 2 illustrates the current regulatory framework for commodity-based instruments with futures-like characteristics. We first review the instruments expressly prohibited and then discuss the various instruments that are excluded or exempted from regulation under the CEA.

PROHIBITED INSTRUMENTS. Prohibited futures contracts in the U.S. stem from the Accord provisions (apart from the 1958 ban on onion futures). The Accord specifies that neither the CFTC nor the SEC may permit trading in futures contracts on individual equity securities or on individual municipal securities. Only cash-settled (but not physical delivery) futures on indexes of such securities that represent at least a substantial market segment are permitted. The rationale for the prohibited futures contracts is the alleged lack of insider trading provisions in the CEA.

EXCLUSIONS AND EXEMPTIONS. As shown in Exhibit 2, the three primary areas offering exclusions or exemptions from regulation under the CEA are 1) the cash forward contract exclusion, 2) the Treasury Amendment exclusion, and 3) those products provided relief through the Commission’s exemptive authority, policy statements, or statutory interpretations.

---

**EXHIBIT 2**

**COMMODOITY EXCHANGE ACT JURISDICTION OVER CONTRACTS WITH FUTURES-LIKE CHARACTERISTICS**

<table>
<thead>
<tr>
<th>Future-Like Contracts</th>
<th>prohibited Instruments</th>
<th>Excluded/Exempted Contracts</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Cash Forward Contract Exclusion</td>
<td>Treasury Amendment Exclusion</td>
<td>Exempted without Futures Designation, e.g., Swaps, Hybrids, Energy Contracts</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>On Exchange</td>
<td>Off Exchange</td>
<td></td>
</tr>
<tr>
<td>CFTC-Directed Contracts</td>
<td>Foreign Contracts</td>
<td></td>
</tr>
<tr>
<td>Leverage Contracts</td>
<td>EFPs</td>
<td></td>
</tr>
<tr>
<td>Exempted Instruments Under General Authority</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Contraled on Non-Exempt Securities</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
Cash Forward Contract Exclusion. Cash transactions or sales of cash commodities for deferred shipment or delivery ("forward contracts") are excluded from the regulatory scheme for futures contracts. Questions have frequently been raised as to what constitutes a forward contract. Factors typically looked to include whether a contract is bilateral with material economic terms subject to individual negotiation, whether the parties have the capacity to make or take delivery, and whether the contracts contain no right to offset.

Treasury Amendment Exclusion. In what has been described as a "flash of awareness" (Schroeder [1986]), the Treasury Department, alarmed at the implications of the exclusivity clause contemplated in 1974, urged Congress at the last minute to take steps to avoid interfering with the smooth functioning of the off-exchange market for foreign currency. As a result, the Treasury Amendment, adopted in 1974, provides an exclusion from the CEA for transactions in foreign currency and other enumerated financial instruments (such as government securities and resales of installment loan contracts).

The language of the Treasury Amendment, which refers simply to "transactions in foreign currency...unless such transactions...[are] conducted on a board of trade," has raised significant questions. A strict interpretation of the statute would suggest no limitations on qualifications of market participants, while a review of the legislative history could suggest that Congress intended to exclude only transactions between sophisticated and informed institutions. This contradiction has prompted significant debate, including what constitutes a sophisticated and informed market participant and what form of trading activity defines a board of trade.

Exemptions Without Futures Determination (The Noose is Loosened). Following an intense four-year reauthorization struggle with the CFTC, other financial regulators, the futures exchanges, and other interested parties in the futures and securities industries, Congress passed the Futures Trading Practices Act, which was signed into law on October 28, 1992.

An important component of this legislation is an amendment to Section 4 of the CEA, which gives the CFTC authority to exempt any agreement, contract, or transaction from the exchange trading requirement or any other requirement of the CEA (except those of the Accord), provided the CFTC determines the exemption is consistent with the public interest (and makes several other determinations). The CFTC is not required to make a determination beforehand, however, that the instrument exempted is a futures contract and thus subject to the CEA. In early 1993 the CFTC acted swiftly in exercising its exemptive authority for certain swap agreements, hybrid instruments, and energy products, including those transacted in the Brent oil market.

Swaps: Swaps are generally viewed as bilateral agreements to exchange a series of cash flows measured by different interest or exchange rates, or commodity prices with payments calculated by reference to a principal or notional amount. Because some contend they resemble futures contracts, the legal status of swaps has been questioned in recent years, with potential applicability of the CEA.

In 1989 the CFTC issued a policy statement that recognized a "safe harbor" from regulation for certain swaps (see the CFTC's "Policy Statement Concerning Swap Transactions," 54 FR 30694 [July 21, 1989]). In January 1993, using its new exemptive authority, the CFTC promulgated rules that essentially codify and update the earlier swaps policy statement (see the CFTC's "Exemption of Swap Agreements," 58 FR 5587 [January 22, 1993]).

The new swap rules identify a "swap agreement," and list entities that are eligible to enter into a swap agreement. The CFTC held that no additional regulation under the CEA is necessary for swaps having the following characteristics: they are not part of a fungible class of agreements that are standardized as to their material economic terms; creditworthiness is a material consideration in entering into the agreement; and they are not entered into or traded on a physical or electronic multilateral transaction execution facility ("MTEF").

The rationale behind the swaps rules is that while swaps may be much like forward contracts, the market may develop to some degree where there may be a role for government. That point is represented by the list of characteristics described in the rules, beyond which government interest may be appropriate to protect the financial integrity of the market.

Hybrids: Hybrid instruments are financial
instruments combining characteristics of commodity futures or options contracts, or both, with securities or depository instruments. As with swaps, legal uncertainty regarding the applicability of the CEA affects these instruments that offer innovative capital-raising and risk management opportunities. Through the years the CFTC has recognized that certain hybrid instruments, although having attributes of commodity options or futures are, nonetheless, mostly not a commodity contract and therefore are most appropriately regulated by institutions with an expertise in the hybrid's predominant function — i.e., as a security or depository interest.

Prior to the 1993 exemption, issuers relied on CFTC regulations promulgated in 1989, which provided an exemption for instruments containing embedded options, and on a statutory interpretation for instruments having components similar to those of futures contracts.28 The new rules provide a single, unified test that can be applied to hybrid instruments containing either futures or option-like components or combinations.

The new rules employ a mathematical test based on contingent claim concepts in an attempt to determine the predominant nature of the instrument.29 Under this test, hybrid instruments are exempt from CFTC regulation if, at the time of pricing for the initial offering, the estimated commodity-dependent value is less than the present value of the commodity-independent payments (e.g., a bond's coupons and principal amount).

As the commodity-dependent payout is typically a piecewise linear function of the price of the underlying commodity, it can be decomposed into a combination of option payouts. Thus, for purposes of the test, the value of the commodity-dependent component is measured by the absolute net value of the put option premiums with strike prices less than or equal to a specified reference price plus the absolute net value of the call option premiums with strike prices greater than or equal to the reference price.

Thus, the rationale underlying the new hybrid rules is essentially one of majority rule. If a product is predominantly a security, securities regulation applies. If it is predominantly a commodity futures or option, the CEA applies.

To illustrate the application of the hybrid rules, consider a firm that issues a structured note whose principal is indexed to the price of oil. Assume that the debt component is a five-year zero-coupon bond worth $621 (the "commodity-independent" value).

At maturity, an investor receives $1,000, plus or minus the difference between the then-prevailing price of oil and a predetermined reference price of $20 a barrel, times fifty barrels. If the price of oil rises above $35 a barrel, the total payment is capped at $1,750 ($1,000 plus fifty barrels times [$35 less $20]).

Thus, this instrument can be viewed as having a futures-like component with a cap. The commodity-dependent component consists of fifty long calls on the price of oil, each having an exercise price of $20, fifty short calls having an exercise price of $35, and fifty short puts having an exercise price of $20.

Assume that the values of the three options are $6, $1, and $6, respectively. Thus, the absolute net value of the put option premiums is fifty times $6, or $300. The absolute net value of the call option premiums is fifty times ($6 less $1), or $250. Thus, according to the rule, the commodity-dependent value is $300 plus $250 or $550.

Since the commodity-dependent value ($550) is less than the commodity-independent value ($621), the instrument would be exempt from regulation under the CEA. If instead the indexing is to seventy-five rather than fifty barrels of oil, the value of the commodity-dependent component would be $825, and the instrument would be subject to regulation under the CEA.

**ON-EXCHANGE FUTURES CONTRACTS.** The CFTC has exclusive jurisdiction over all domestic futures activity and generally requires that all futures contracts be traded on a designated contract market. Similarly, foreign futures marketed into the U.S. are required to be listed on a foreign board of trade, exchange, or market.

**CFTC-Designated Contracts.** All domestically traded futures contracts must be executed on a commodity exchange that has been designated by the CFTC. The CFTC's Guideline No. 1, last revised in 1992, specifies the economic conditions for a new contract to receive trading approval. The major requirements are that the terms and conditions generally conform to cash market practices and that an adequate deliverable supply exists, or, in the case of a
cash-settled contract, that the final settlement price will not be readily susceptible to manipulation or distortion. Further, the CFTC must have reasonable belief that the contract could be used for hedging or price basing.

Included among the futures the CFTC regulates are contracts on exempt securities. Exempt securities are those not required to meet the registration requirements of securities laws and SEC regulations and include such instruments as Treasury securities and other securities guaranteed by the federal government. Certain foreign government debt securities are exempted by the SEC for purposes of futures trading. While the CFTC seeks the views of the Treasury, the Federal Reserve, and the SEC when considering designation of contracts on exempt securities, Congress did not grant those agencies veto power over the approval of such contracts.

**Foreign Futures Contracts.** Futures that are listed on a foreign board of trade (other than futures on stock indexes, non-exempt foreign government debt, and other securities that are subject to the Accord provisions) can be offered and sold by U.S. firms in the U.S. without restriction. Furthermore, relief from CFTC registration requirements is provided to foreign firms marketing such products in the U.S. if the home country has a comparable regulatory scheme to that of the U.S. Foreign jurisdictions receiving comparability relief include the United Kingdom, France, Canada, Singapore, Australia, and Japan. Germany and Italy have not.

**Contracts on Non-Exempt Securities.** Under the Accord, the CFTC has jurisdiction over futures on a group or index of securities. The CFTC may not approve any such contract if the SEC vetoes such a contract by determining, within forty-five days following the close of the public comment period, that the contract does not meet the Accord requirements. The criteria include that the contract be cash-settled and not readily susceptible to manipulation, and that the underlying index be broad-based or representative of a substantial segment of the market.

For futures on non-exempt securities listed on foreign boards of trade, certain procedures are followed according to agency practice. For foreign stock index futures, the CFTC's general counsel first issues a no-action letter upon conferring with the SEC. For futures on foreign government debt, the security must first be designated as an exempt security for purposes of futures trading by the SEC before the futures can be marketed in the U.S.

**OFF-EXCHANGE**

**Leverage Contracts.** One commodity-based instrument exempt from the exchange trading requirement is the leverage contract. Leverage contracts are standardized contracts for the long-term (typically ten years or more) purchase or sale of a commodity. Currently, the only eligible commodities are gold and silver bullion and coins, bulk gold or silver, and platinum. While transactions in leverage contracts occur off-exchange, merchants of such contracts are subject to significant CFTC regulations, including anti-fraud rules, registration requirements, delivery specifications, and minimum financial, cover, and segregation requirements. Currently, there are no active registered leverage firms.

**Exchange of Futures for Physicals (EFPs).** EFPs are transactions in which the buyer of a cash commodity transfers to the seller a long futures contract, or receives from the seller a short futures, at a mutually agreed-upon price difference. EFPs provide commercial market users a means of pricing a cash transaction or taking delivery on their futures commitments outside the normal exchange delivery systems, thus permitting them to offset exchange positions through a privately negotiated transaction. While not covered by the exchange trading requirement, CFTC regulations stipulate certain recordkeeping and reporting requirements of cash transactions underlying EFPs.

**Exempted Instruments under General Authority.** The 1992 Futures Trading Practices Act gives the CFTC authority to exempt any agreement, contract, or transaction from the exchange trading requirement. This authority also extends to instruments that have been designated by the CFTC as futures contracts. To date, the CFTC has not exempted any such futures, although it has been petitioned by the CME to grant an exemption to its rolling spot foreign exchange contracts, previously designated as a futures by the CFTC.30

**Regulation of Option-Like Contracts**

Exhibit 3 illustrates the current regulatory framework for commodity-based instruments having
option-like characteristics. Because of a more colorful trading history, options have been subject to greater regulatory scrutiny than futures.

EXCLUSIONS AND EXEMPTIONS

Exclusions for Options on Securities. The Accord provides that the CFTC has no authority to regulate or oversee the regulation of any option on a security or on an index of securities.

Exclusion for Listed Options on Foreign Currency. The Accord also excludes options on foreign currencies traded on national security exchanges from the provisions of the CEA. Currency options may also be listed on commodity exchanges. Prior to enactment of the Accord, currency options were traded only on securities exchanges, and had not yet gained wide use in the OTC market.

Exemption for Hybrid Option Instruments. The 1974 amendments to the CEA provided the CFTC with plenary authority to exempt options from regulation. In 1989 the CFTC first issued regulations to exempt hybrid instruments containing commodity-like options, if, at the time of issuance, the value of the embedded option did not exceed 40% of the instrument’s value. Furthermore, granted or short options (other than those to cap a long position) were not permitted.

The 1993 hybrid rules expand the permissible size of the option component so as not to exceed the value of the commodity-independent component. Also, no restrictions are placed on granted options as long as the purchaser is not required to make any subsequent out-of-pocket payments to the issuer following the issuance of the instrument.

ON-EXCHANGE COMMODITY OPTIONS

CFTC-Designated Contracts. Before commencing trading, the CFTC must designate all exchange-traded options on futures and options on physical commodities. In 1981 the CFTC adopted regulations providing for a pilot program for exchange-traded options on futures except for those on the enumerated agricultural commodities. In 1983 a second pilot program was initiated for exchange-traded options on physical commodities (again, except for the enumerated commodities). In 1984, in response to the 1982 amendments to the CEA that removed the ban on agricultural commodity options, the CFTC’s regulations were amended to allow for exchange-traded options on futures in the enumerated commodities, but to date no relaxation of the rules has been extended to physical options for these commodities.

In 1992 the designation requirement for options was substantially revised. For futures options, an exchange must simply certify that it has rules conforming to standards set forth in a seven-point checklist. Included in this list are standards for speculative limits, aggregation rules, minimum reporting levels, strike price listing procedures, dates for option expiration, minimum tick size, and daily price limits, if any. For physical options, an exchange in addition must justify the terms and conditions of the contract that would similarly apply to a futures on the same commodity.

Options on Futures on Non-Exempt Securities. As is the case with futures on non-exempt securities, the Accord provides the CFTC with jurisdiction over options on futures contracts based on a group or index of non-exempt securities. As with the underlying futures, the SEC also has a veto over the designation of such option contracts.

Options on Foreign Futures. After the 1978 suspension of commodity option transactions, no foreign options could be marketed in the U.S. Further, the options pilot program did not include a provision for foreign futures. In 1988 the CFTC established procedures for authorizing, by order on a case-by-case
basis, options contracts traded on or subject to the rules of a foreign board of trade. While futures traded on or subject to the rules of a foreign board of trade may be marketed without restriction, however, options on foreign futures must satisfy an extensive set of requirements. This may be viewed as a lingering effect of the options ban discussed earlier.

In evaluating a request for such an order, the CFTC considers whether sufficient arrangements exist for preventing sales practice abuses, arrangements for U.S. customers to redress grievances, the existence of a comparable regulatory structure, and the existence of information sharing agreements between the CFTC and the relevant exchange or government agency. If the CFTC has already approved an option listed on a foreign board of trade, it may choose not to perform a complete review for subsequent requests.

For options on foreign futures in non-exempt securities, the same special procedures applicable to the underlying futures must be followed.

**OFF-EXCHANGE COMMODITY OPTIONS.**

With respect to other products in the OTC market, the CFTC has regulations regarding two forms of commodity option instruments that are exempt from the exchange-trading requirement. These include trade options on non-agricultural commodities and dealer options.

**Trade Options.** Trade options are off-exchange options entered into through normal commercial channels. The 1936 amendments to the CEA banned options for certain agricultural commodities. In 1976 the CFTC adopted regulations allowing trade options except for those on the enumerated agricultural commodities. The regulations specify that the purchaser have a reasonable basis to believe that the option is offered to a commercial user that enters into the transaction solely for purposes related to its business. The CFTC has more recently proposed extending the exemption to include the enumerated agricultural commodities. This proposal is still pending.

**Dealer Options.** Dealer options are options granted by a person domiciled in the U.S. who, on May 1, 1978, was both in the business of granting options on physical commodities and in the business of buying, selling, producing, or otherwise using that commodity. Dealer options may be marketed only through futures commission merchants, and grantors must have a net worth of at least $5 million and meet certain other requirements, including segregation of customer funds and recordkeeping.

Since the advent of exchange-traded commodity options in 1981, the dealer option market has declined. At the present time, there are no active dealers in this market. The last dealer option report was submitted to the CFTC in September 1990.

**III. CONCLUDING COMMENTS: HOW CAN ECONOMISTS HELP?**

A primary purpose of this article has been to describe the current regulatory landscape for derivative products. It is important for economists to join in this debate, because regulation is a primary factor influencing financial innovation. Financial engineers must contend with the risk that an innovative new instrument is sufficiently futures-like that it becomes subject to the CEA. If so, the exchange-trading requirement, in many cases, effectively prevents it from coming into existence in the U.S. As a result, it is not surprising that so much regulatory attention has focused on the debate of what is a futures versus a forward contract, or when is a hybrid security mostly not a futures or an option.

An aspect of the futures versus forward contract analysis that has received considerable attention among economists is the influence of many of the facilitating features on futures prices. Examples of the many studies include the influence of margining and daily resettlement (Cox, Ingersoll, and Ross [1981]; Elton, Gruber, and Rentzler [1984]; French [1983]; and Muehlbrock [1992]); taxes (Cornell [1981]); delivery options (Gay and Manaster [1984]); and a central auction and clearinghouse (Kamara [1988]).

Many interesting issues remain. For example, what has been the influence of legal uncertainty on prices of derivative instruments? What are the economic implications for a broad versus narrow definition of a futures? With the new exemptive authority the CFTC received in 1992 with the passage of the Futures Trading Practices Act, what kinds of exemptions should it provide in order to allow the appropriate innovation to occur?

What kinds of regulation, if any, should there be accompanying these exemptions — on the instru-
ments, on the trading systems, and on the participants? If intermediaries and end users are subject to regulation, is it necessary to regulate the products themselves? Is the concept of a single, superregulator a superior framework? If so, should regulatory oversight be separated along functional lines or by institutions? Alternatively, is regulatory competition among multiple regulators more conducive to innovation and appropriate oversight?

While these questions are important, we believe there are even more important issues than simply debating what is a futures versus forward contract. For example, what is government's interest or appropriate role to permit the markets for derivative instruments to develop in an environment that is most conducive to growth and innovation, while ensuring that markets are open, competitive, and of sound integrity?

Certainly, regulators must carry out the intent of Congress and the statute. Within that framework, however, regulators, before recommending government intervention, should consider whether externalities exist, what market solutions exist for mitigating them, and whether government intervention provides net benefits.

ENDNOTES

The authors have benefited from discussions and helpful comments from Joanne Medero, Bob Clark, Steve Sherrod, Paul Architzel, Katherine Daigle, Ray McKenna, Bob Zwirb, Owen Gregory, Tom Leahy, John Stassen, Atlanta Finance Workshop participants, and an anonymous reviewer. The views expressed are those of the authors and do not necessarily represent the views of the Commodity Futures Trading Commission or its staff.

1Taken from the August 21, 1978, letter sent by the Securities and Exchange Commission (SEC) to the Commodity Futures Trading Commission (CFTC) regarding the first stock index futures contract application.

2A no-action letter is usually written in response to a request for a clarification of a rule or law. It lists specific conditions under which the staff of a regulatory agency will not recommend an enforcement action.

3See, for example, Miller [1992] and Merton [1992].

4The CEA provides a comprehensive scheme for the regulation of transactions in commodity futures and options, of the exchanges, and of industry participants, including futures commission merchants (FCMs), commodity trading advisors (CTAs), and commodity pool operators (CPOs).

5The appendix identifies all abbreviations used.

6For a discussion of the exchanges' early efforts to oppose bucket shops, see Lurie [1979].

7See Mulherin, Netter, and Overdahl [1991] for a discussion of the way the courts, through the establishment of property rights over exchange-generated quotations, can permit an exchange to reap gains from investing in new trading technology.


9The major exceptions include cash and forward contracts, instruments covered under the Treasury Amendment and the Shad-Johnson Accord, and certain swap and hybrid instruments. These exceptions are discussed later.

10Specifically, the Treasury Amendment states "Nothing in this Act shall be deemed to govern or in any way be applicable to transactions in foreign currency, security warrants, security rights, resales of installment loan contracts, repurchase options, government securities, or mortgages and mortgage purchase commitments, unless such transactions involve the sale thereof for future delivery con-
ducted on a board of trade."

11See the 1933 "Annual Report of the Chief of the Grain Futures Administration."

12The underlying authority for the Code was invalidated by the Supreme Court, as it was found to be an unconstitutional delegation of Congressional authority to the President. See Schechter Poultry Corp. v. United States, 295 U.S. 495 (1935).

13The 1934 "Annual Report of the Chief of the Grain Futures Administration" states that the price decline was attributable to about ten traders who had accumulated large futures holdings in wheat and corn and subsequently placed the large positions onto the market. The large traders were well-capitalized, and the liquidation was for profit-taking as opposed to other large accounts, which were less well-capitalized, who were forced to liquidate.

It is also interesting to contrast the exchange statement with those reported immediately following the resumption of privilege trading in 1926. Grain traders claimed that puts and calls were stabilizers of value and that they tended to restrict price fluctuations (Chicago Tribune, January 12, 1926, p. 12).

14This case provided the impetus for rules requiring fingerprinting of all Commission registrants.

15In February 1982, nearly four years later, the CFTC finally gave approval to the KCBT’s application to trade a stock index futures based on the Value Line Average. The delay was due to a combination of factors, including Dow Jones’s objection to the originally proposed contract on the 30 Industrial Stock Average, a subsequent attempt by the KCBT to base the contract on the S&P 500 only to encounter the Chicago Mercantile Exchange’s similar attempt, and the reluctance of the CFTC chairman (prior to 1982) to approve stock index futures.

16"Exempt" means either exempt from SEC registration requirements (except for individual municipal securities, as the Accord prohibits all futures on these) or exempted by the SEC for purposes of allowing futures trading on such instruments as foreign government debt.

17An entity regulated as an investment company is subject to limitations in organizational structure and dealings with affiliates and must comply with certain reporting, recordkeeping, and disclosure requirements.

18That is, a securities broker must pass an additional examination and become authorized to sell a product deemed to be a futures. In addition, clients of a securities broker must fill out separate account documents in order to trade futures.

19An additional factor contributing to legal uncertainty in financial markets is the potential for an ultra vires action, or a determination that a transaction is beyond the legal capacity of a counterparty. Such an event occurred in the case of Hazell v. The Council of the London Borough of Hammersmith and Fulham and Others. In this case the district auditor for Hammersmith and Fulham sought a declaration that swap transactions entered into were beyond its capacity and were thus unlawful. Subsequently, the House of Lords decided that local authorities have no power to enter into swap contracts.

20This is not unlike many statutes that do not provide definitions of key concepts, thereby providing greater flexibility in enforcement. Other examples include the absence of a definition of an "investment contract" in the Securities Act of 1933. Also, there is no explicit statutory prohibition, or statutory definition, of "insider trading." Instead, the law of insider trading has been judicially developed from the generally worded anti-fraud provisions of the Securities Exchange Act of 1934. Similarly, the Federal Trade Commission Act allows the FTC to prohibit "unfair methods of competition" and "unfair or deceptive acts or practices," yet does not provide a definition of either term.

21Facilitating characteristics may include: standardized terms and conditions; offered directly or indirectly to the public; secured by earnest money or margin deposit; traded on a centralized market; prices disseminated to the general public; conveys no interest in any particular unit; and uses a clearing organization that matches trades and guarantees counterparty performance.

22See the CFTC’s "Statutory Interpretation Concerning Forward Transactions," 55 FR 39188 (September 25, 1990).

23Criteria considered by the CFTC and the SEC as defining a substantial market segment include: 1) the index is made up of twenty-five or more securities; 2) the value of the index exceeds $75 billion in total capitalization; 3) the weight of any single security does not exceed 25% of the total index; and 4) the combined weight of the three largest securities is less than 45%. For a more detailed discussion, see “Designation Criteria for Futures Contracts and Options on Futures Contracts Involving Non-Diversified Stock Indexes of Domestic Issuers,” 49 FR 2884 (January 24, 1984).

24It is interesting to note that futures in individual stocks are traded on foreign boards of trade. Also, the original stock index futures offered on the Osaka Securities Exchange featured a physical delivery option, thus prohibiting its sale in the U.S.

25The CFTC does retain authority to investigate manipulations in cash (including forward) transactions in all enumerated commodities and in commodities in which futures have been designated.

26Many of these issues have been raised in Salomon
The CFTC did reserve to itself the anti-fraud and anti-manipulation authority.

For rules for hybrid option products, often referred to as the "mostly not an option" rule, see the CFTC's "Regulation of Hybrid Instruments," 54 FR 30684 (July 21, 1989). For guidelines for hybrid futures products, often referred to as the "blank-denominated bond or deposit" rule (e.g., gold- or yen-denominated bond), see the CFTC's "Statutory Interpretation Concerning Certain Hybrid Instruments," 54 FR 1139 (January 11, 1989) and 55 FR 13582 (April 11, 1990).

A detailed description of the test can be found in two Federal Register notices: 57 FR 53618 (November 12, 1992) and 58 FR 5580 (January 22, 1993).

A summary of this petition along with the CBT's request for a "professional trading market" exemption is found in the CFTC's "Exemption for Certain Exchange-Traded Futures and Options Contracts," 58 FR 43414 (August 16, 1993).

REFERENCES


