

Reinvigorating the Commodity Exchange Act by Closing the Treasury Amendment Loophole

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IN 1980, WHILE I WAS in Hong Kong, my hosts took me to visit what was billed as the third-largest gold futures market in the world. In the middle of the night, which coincided with business hours in the U.S., I visited an active trading room, where terminals flashed prices and cigar smoke filled the air. Traders chatted on phones while watching Chicago Mercantile Exchange (CME) and Chicago Metal Exchange prices on flickering screens. When a “buy” order came in the trader offered the unsuspecting buyer a price as much as \$10 per ounce above the exchange-traded prices. The trader hoped to match that order with a “sell” order called in elsewhere in the room. The “sell” might be quoted a price \$10 below the market for a \$20 spread that this “bucket shop” could pocket. Perhaps the blissfully uninformed customers were satisfied with the prices. But, if they believed they were trading in a fair auction market, where competition and price transparency ensure fair prices, they were woefully deceived.

The Commodity Exchange Act

The Commodity Exchange Act (CEA) is the basis of customer protection for traders in U.S. commodities. First enacted in 1922, the act sought to regulate the grains that comprised the futures industry of that day.

As amended, the CEA applies today to a wide variety of financial futures and options markets whose only relationship to the original agricultural markets from which they sprang are their basic risk management and price discovery functions.

Amendments to the CEA have attempted to keep pace with the futures industry as it exists today, but there are gaps, loopholes, and patches of overregulation that need to be streamlined. Before the beginning of the current administration in 1992, I was invited to participate in President Bill Clinton’s “Economic Conference” in Little Rock, AR. At that conference, I urged that government regulators be required to weigh the cost of a regulation against its benefit, so that U.S. business could be nurtured rather than stifled by the complex financial regulatory system. At the President’s request, I developed my concepts into a thorough restructuring of federal financial regulation. The resulting CME model has been the source of much debate and discussion over the past four years.

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Reinvigorating the CEA

A revitalization of the CEA is now in order, and, in a rare show of unanimity, the seven U.S. futures exchanges submitted testimony to the U.S. Senate Committee on Agriculture, Nutrition, and Forestry on June 5, 1996, at the invitation of its chairman, Senator Richard G. Lugar. In this testimony, the exchanges suggested a number of proposals to reinvigorate the CEA:

- Commodity Futures Trading Commission (CFTC) rulemaking should be governed by a cost-benefit analysis.
- The audit trail requirements should be clarified so that exchanges will not be diverted from the goal of deterring and detecting rule violations in favor of pursuing high technology.
- The CFTC's routine pre-approval process for new contracts and rules should be eliminated.
- True regulatory oversight of Self Regulated Organization's (SRO) disciplinary activities should be implemented.
- For persons seeking to re-register as floor brokers or traders, SRO and CFTC penalties that have been satisfied should not be the sole basis for adverse actions.
- The exchanges are entitled to fair and evenhanded treatment on exemptions.
- The Treasury amendment must be refined to provide legal certainty and to eliminate the opportunity for unscrupulous operators to escape CFTC jurisdiction.

This article will focus principally on the last of those recommendations, beginning with a look at the need for urgent action on the Treasury amendment.

Unscrupulous operators

To find the latest twist in "bucket shops" like the ones I visited in Hong Kong, an

individual need only surf the Internet today on the lookout for new investment opportunities. Tracking down a surprising number of sites offering currency futures trading, a "surfer" will discover that some of the sites even call themselves "exchanges." The unwary investor is invited to "fly with the eagles," joining "the same 'exclusive club' of the smart and the 'old money' of the world."¹ The electronic trading room promises:

- High rate of return: A 100 percent return on investment in a given year is not uncommon, due to the volatility of currency markets.
- Leverage: Flexibility and maximum usage of capital is allowed by margin trading with only 5 percent cash, without "margin calls."²

This "Internet exchange," and others like it, are simple, technologically sophisticated boiler rooms and bucket shops soliciting the public to trade dollars against foreign currencies. Some legitimate-looking sites permit trading for as little as a \$10,000 margin deposit. I've seen one site that offers to take accounts with as little as \$100 deposits.

Electronic trading rooms offer trading without commissions. There also happen to be no financial protections and none of the execution protection or centralized market pricing that characterize currency futures transactions.

"Isn't this great," an ad in a financial periodical recently boasted. "You can get a futures options position without paying a commission to a broker." These operators are unlikely to describe the risks of their deals before they take their customers' money. There is no restraint on selling to the customer high above the real market and buying back well below the real market, rather than giving their customers a fair price. The real question is, are they going to be there if their

customers make a substantial winning trade?

The Treasury amendment

These off-exchange futures markets operate based on a loophole in the 1974 Treasury amendment to the CEA. By way of background, the CME created financial futures in 1972 by establishing its International Monetary Market (IMM). The IMM was created to trade foreign currency futures in the wake of the breakdown of the Bretton Woods Agreement, which had fixed foreign exchange rates since the end of World War II. These first financial futures revolutionized the futures markets, leading to new ways of managing the risks of foreign exchange and, ultimately, to other innovations in risk management. For two years, the CME operated the IMM division without problem, despite the lack of direct regulation. Congress, however, became convinced that all futures contracts, whatever the underlying commodity, ought to be subject to the same regulatory regime.

The CFTC was established with the 1974 revision of the CEA to oversee futures exchanges and to expand the CEA's coverage beyond agricultural commodities to "all other goods and articles, ... and all services, rights, and interests in which contracts for future delivery are presently or in the future dealt in."³ Very late in this legislative process, however, the U.S. Department of the Treasury raised the concern that the inclusion of this broader range of futures contracts within the CFTC's jurisdiction could impinge upon Treasury's jurisdiction over banks and the traditional bank forward market. Treasury obtained Congress' agreement that there was no reason to include within the CFTC's jurisdiction a market that was already governed by bank regulators. The Treasury amendment became law on the assumption that the language drafted by Treasury narrowly carved out transactions that were subject to an existing regulatory regime. The language

of the amendment became the source of future confusion:

Nothing in [the Commodity Exchange] 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 conducted on a board of trade.⁴

Confusion and controversy

Controversy over the Treasury amendment's meaning was immediate, and it has intensified with litigation now before the Supreme Court.⁵ The futures exchanges asserted that the amendment was intended to apply solely to the cash forward market and to restrict the CFTC's activities in that sphere, taking what they considered the most natural reading of the phrase "transactions in." The amendment was not intended to exempt futures trading in foreign currency in every case in which the parties choose not to use the facilities of an organized futures exchange. While the CFTC initially agreed, it later shifted its ground to concede that the amendment curtailed its jurisdiction, but only with respect to off-exchange transactions between regulated banking entities. The language of an early interpretative letter concluded that the exemption applied to "an informal market among institutional participants ... so long as it is supervised by those agencies having regulatory responsibility over those participants."⁶ In 1985, the CFTC made "very clear that any marketing to the general public of futures transactions in foreign currencies conducted outside the facilities of a contract market is strictly outside the scope of the [Treasury] amendment."⁷

Yet the CFTC contributed to the confusion by seeking public comment to help it

define what persons qualify as “sophisticated and informed institutions,”⁸ implicitly expanding the reach of the amendment from regulated bank markets to all transactions among sophisticated parties. Nothing in the legislative history or in the amendment itself supports this approach, and the CFTC has taken no further or final action to pursue this line of reasoning.

On the third front, the banks and Treasury pushed for a complete regulatory exemption for all off-exchange transactions. Treasury’s position eventually led to the posture that all transactions in a broad list of financial futures, including currencies and government securities, could escape regulation, no matter the character of the parties, if the transactions were not consummated on an exchange. Some courts are siding with the Treasury Department, handcuffing the CFTC’s enforcement efforts and destroying the basis for exchange trading of futures. A number of cases are moving toward resolution, presumably by the Supreme Court of the United States.⁹

Supreme Court to review Treasury amendment

A recent decision by the Second Circuit Court of Appeals, *CFTC v. Dunn*,¹⁰ will give the U.S. Supreme Court a chance to take a look at the Treasury amendment. In *CFTC v. Dunn*, the defendants claimed to be investing in exotic currency options positions on behalf of their customers. The Second Circuit found that the defendants were:

engaged in an old-fashioned ‘Ponzi’ scheme, accompanied by exotic financial vocabulary. ... The losses, however, were too great to be offset by ‘roll-overs’ or the money, and much of the investors’ money has disappeared.¹¹

Nevertheless, the defendants sought to defeat the CFTC’s motion for an equity receiver by arguing that the district court

lacked subject matter jurisdiction because the Treasury amendment deprived the CFTC of power to regulate options on foreign currency. The Second Circuit, considering itself bound by its 1986 decision,¹² ruled that defendants could not invoke the Treasury amendment to avoid CFTC jurisdiction because the purchase or sale of an option did not qualify as a “transaction in foreign currency” until the option was exercised.

The Second Circuit explicitly recognized that its position was in conflict with a decision of the Fourth Circuit and invited the Supreme Court to resolve the conflict. On May 27, 1996, the Supreme Court granted the defendant’s writ of certiorari in the *Dunn* case. The question presented for review is whether the Treasury amendment prevents the CFTC from bringing the judicial enforcement action arising from fraud in the solicitation of investment in over the counter foreign currency option contracts.

Given the narrow question presented, it is not clear that the Supreme Court will reach past this narrow options issue to decide the broader fundamental jurisdictional issue. If the Supreme Court does reach this fundamental issue, there can be no basis for confidence that the decision will favor the CFTC’s position or the victims of these currency trading scams.

Abuse of public customers

However, the growing abuse of public customers and the injury to organized markets that has resulted from the ambiguous drafting of the Treasury amendment deserves special notice. Because the Treasury amendment is most abused by currency dealers, the CME has borne the greatest competitive burden in consequence of the regulatory disparity between CFTC-designated exchanges and the off-exchange market.

Unregulated bucket shops, Internet dealers, and other retail enterprises are taking

advantage of the public, evading the intense regulation mandated for futures trading and siphoning liquidity away from markets. These operations must be shut down or brought within the regulatory purview of the CFTC, the National Futures Association, and regulated futures exchanges—the institutions and agencies who best know how to police this kind of trading activity.

A simple equation for determining who are the “sophisticated” investors and institutions and who should be allowed to continue their foreign exchange activities from inside the Treasury amendment’s exemption would be those foreign currency transactions valued above a particular threshold, perhaps \$5 million or some other appropriate size. Transactions on that scale are the hallmark of the banks and other investment institutions currently participating in the trillion dollar a day foreign exchange market. Those “sophisticated” enough to invest above this threshold amount in foreign exchange do not need the same level of regulatory safeguards and oversight as those individuals and institutions investing lesser amounts in the huge foreign exchange market. If smaller investors are restricted to using exchange markets, they have much to gain when they are no longer at the mercy of bucket shops acting as broker, counterparty, quote disseminator, audit trail compiler, and final arbiter to their “customers”—all at the same time.

Legislative initiatives

Following up on the testimony I gave before the Senate committee on June 5, I urged the members of that panel not to leave the interpretation of the Treasury amendment up to the Supreme Court, but to close the loophole that several courts have already interpreted as keeping even some of the most blatant and fraudulent foreign current dealers outside the purview of regulations designed to protect the public. I am extremely heartened that on August 2, 1996, Senator

Lugar and the committee’s ranking Democratic member, Senator Patrick J. Leahy, issued a joint statement endorsing the substance of the proposals the exchanges made, including revising the Treasury amendment. The senators indicated they will introduce the bill in September, after giving the CFTC, Treasury, and other relevant agencies a chance to arrive at a common interpretation of the amendment.

Congress has worked long and hard to develop a regulatory structure and a balance that both protects the public and nurtures the liquidity of an industry whose roots are uniquely American but now stretch to the farthest corners of the globe. With the new initiatives to be introduced in the coming months, regulation can be clarified and streamlined to face the challenges of the next millennium.

Notes

¹Home Page of NETWORKTOOL Foreign Currency Trading Program, (<http://www.entrepreneurs.net/adventure/networktools/currency/html>). Text appears as quoted on May 26, 1996.

²Ibid.

³CEA, Sec. 1a.(3).

⁴Ibid., Sec. 2.(a)(1)(A)(ii).

⁵*CFTC v. Dunn*, 58 F.3d 50 (2nd Cir. 1996), cert granted May 28, 1996, No. 95-1181; see *infra* text accompanying Note 10.

⁶CFTC Interpretative Letter No. 77-12 (Aug. 17, 1977).

⁷Trading in Foreign Currencies for Future Delivery, CFTC Statutory Interp., [1984-1986 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶22,750 (Oct. 18, 1995).

⁸Ibid.

⁹*CFTC v. Frankwell Bullion Ltd*, No. C-94-2166 DLJ, 1994 WL 449071 (N.D. Cal. Aug. 14, 1995); *Salomon Forex, Inc. v. Tauber*, 8 F.3d 966 (4th Cir. 1993), cert denied, 114 S. Ct. 1540 (1994).

¹⁰*CFTC v. Dunn*, 58 F.3d. 50 (2d Cir. 1995).

¹¹Ibid.

¹²*CFTC v. American Bd. of Trade*, 803 F.2d 1242 (2d Cir. 1986).