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THE MECHANICS OF FUTURES TRADING: SPECULATION AND MANIPULATION

*Joseph J. Bianco**

If the House of Representatives aptly characterized the futures markets as "volatile and esoteric,"¹ it is the task of this Symposium generally, and this article in particular, to render the subject less esoteric. To understand the issues discussed in this Symposium, it is essential to understand the mechanics of futures markets in a contemporary context.

A "future" is common parlance for the standard vehicle of commodities trading, the contract for future delivery. A futures contract is a bilateral executory agreement which provides that the seller will deliver to the buyer a specified amount of a particular grade of a given commodity at a stated place and future time.² The futures contract developed to insulate farmers and food processors from the enormous seasonal and cyclical risks inherent in the production and distribution of perishable food products.³ The establishment of exchanges in the nineteenth century mitigated the problems which developed as American agricultural production vastly expanded. Futures exchanges were a stabilizing force in the risky, unpredictable, and unstructured nineteenth century farm industry. Exchanges enabled the fragmented midcentury farm structure to evolve by 1900 into an efficient production and marketing system.⁴

From these roots emerged the erroneous but durable notion that futures trading is a purely agricultural phenomenon, a mere byproduct of the farming and marketing of food. Unfortunately, early federal regulation of commodities trading reflected this popu-

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1. H.R. REP. NO. 975, 93d Cong., 2d Sess. 1 (1974).

2. For a discussion of the terms of futures contracts, see T. HIERONYMUS, *ECONOMICS OF FUTURES TRADING* 36-40 (2d ed. 1977).

3. *General Guide*, COMM. FUT. L. REP. (CCH) ¶ 104 (1977).

4. For a discussion of the important role of commodities exchanges in the development of modern American agriculture, with international comparisons, see J. BAER & O. SAXON, *COMMODITY EXCHANGES AND FUTURES TRADING* 10-18 (1949).

lar misconception.⁵ The forerunner of the Commodity Futures Trading Commission (CFTC)⁶ was the Commodity Exchange Authority (CEA).⁷ The CEA conducted its operations within the aegis and physical confines of the United States Department of Agriculture (USDA).⁸ It is generally believed that the CEA's location and its consequent outlook contributed markedly to its inability to control market abuses.⁹ Because of its ineffectiveness, the CEA was abolished by the Commodity Futures Trading Commission Act of 1974 (the CFTC Act).¹⁰

Passage of the CFTC Act may indicate congressional acceptance of the notion that commodity futures are not agricultural items; however, as Commissioner Rainbolt notes, futures are still primarily regarded as ancillary to the marketing of agricultural products.¹¹ In light of the history of federal regulation, this misconception is understandable. It is, however, intolerable. Futures are not commodities; commodities are not futures. An analysis of this seemingly facile distinction can aid in comprehending not only the true nature of the markets, but the proper goals of CFTC regulation as well.

"Commodities" are physical products. Many commodities underlying futures are agricultural; many are not.¹² However, every commodity differs fundamentally from a similarly denominated future. For example, while a simple cash transaction in wheat is unquestionably an agricultural event, trading wheat futures in an open outcry auction market requires a level of sophistication that greatly exceeds that required for cash trading. The relationship between the cash market and the futures market is complex and sub-

5. For a history of federal regulation of futures trading, see Rainbolt, *Regulating the Grain Gambler and His Successors*, 6 HOFSTRA L. REV. 1 (1977).

6. The Commodity Futures Trading Commission (CFTC) was created by the Commodity Futures Trading Commission Act of 1974, Pub. L. No. 93-463, § 101(a), 88 Stat. 1389 (codified at 7 U.S.C. § 4a (Supp. V 1975)).

7. The Commodity Exchange Authority (CEA) was the administrative arm of the Commodity Exchange Commission. The Commission was created by the Commodity Exchange Act, ch. 545, § 3, 49 Stat. 1491 (1936) (repealed 1974).

8. T. HIERONYMUS, *supra* note 2, at 314.

9. See H.R. REP. NO. 975, 93d Cong., 2d Sess. 42-44 (1974); Note, *The Role of the Commodity Futures Trading Commission Under the Commodity Futures Trading Commission Act of 1974*, 73 MICH. L. REV. 710, 717-18 (1975).

10. Pub. L. No. 93-463, § 101(a), 88 Stat. 1389 (amending 7 U.S.C. § 2 (1970)).

11. See Rainbolt, *supra* note 5, at 8.

12. Futures contracts for 39 different commodities were traded during August 1977. FUTURES INDUSTRY ASSOCIATION INC., BULL. NO. 2886, FUTURES CONTRACTS TRADED AUGUST 1977 (1977). Approximately half the commodities were agricultural. See *id.*

tle. There is only an indirect price relationship between the two.¹³ Cash price reflects supply and demand at a particular time and place, but futures price reflects anticipation of supply and demand across time and regardless of place. Although futures price approaches "spot" price¹⁴ as the contract expiration date approaches, futures contracts frequently go off the board at a price that differs substantially from the corresponding cash price.¹⁵

The reasons for this discrepancy between cash price and futures expiration price are complex. Fundamentally, it is not a function of futures markets to provide a source of supply for the commodity itself.¹⁶ Thus, physical delivery and receipt of a commodity take place on fewer than one percent of outstanding futures contracts.¹⁷

Although cash commodity transactions in agricultural items might logically be regulated by an arm of the USDA, futures are more appropriately regulated by an agency with market experience and broader perspective. Futures regulation by the USDA is analogous to the regulation of "transportation" securities by the Interstate Commerce Commission. While the Interstate Commerce Commission was established to deal with the everyday functions of transportation businesses, that Commission could not deal effectively with the trading of equity securities. Commodity futures markets are often miscast as forums for the exchange of tangibles. Insofar as they are intangibles and insofar as their prices are sub-

13. For a discussion of this relationship, see Telser, *Futures Trading and the Storage of Cotton and Wheat*, 66 J. POLITICAL ECON. 233 (1958).

14. "Spot" price is "[t]he price at which the physical commodity is selling." S. REP. NO. 1131, 93d Cong., 2d Sess. app. IX, reprinted in [1974] U.S. CODE CONG. & AD. NEWS 5843, 5894.

15. A reading of the commodities page of *The Wall Street Journal* will demonstrate the differences between cash prices and prices of futures which are about to expire. Compare Wall St. J., Oct. 31, 1977, at 6, col. 4 (lumber spot price) with *id.* at col. 5 (lumber futures price).

16. T. HIERONYMUS, *supra* note 2, at 204.

17. *Id.* at 41. There are two alternative methods of legally extinguishing a futures contract once it has been purchased or sold through an exchange. *Id.* The more common method of liquidation is to offset the original trade by taking an opposite position in the same market sometime before the contract expiration date. *Id.* at 42. On rare occasions, a speculator or hedger will fulfill his contractual obligation by effecting physical delivery of the commodity. *Id.* at 41. Formerly, futures contracts in which neither party ever intended to make any physical transfer, and in which both parties intended at the time of contracting that the contract was to be settled by payment only of differences in price, were regarded as gambling and voided as contrary to public policy. See, e.g., *Peto v. Howell*, 101 F.2d 353, 362 (7th Cir. 1938). This notion evidences a basic misunderstanding of the markets, and contributes to the suspicion that often surrounds futures speculation.

ject to the peculiar vagaries of crop forecasts, consumption estimates, and meteorological forecasts, futures contracts should be regulated in the same manner as corporate securities,¹⁸ whose prices are determined by the equally uncertain predictions of book value and earnings. Securities are to their underlying corporations as futures are to their underlying commodities. Trading the rights to an item on an organized exchange is distinguishable from trading the item. Because farm futures markets are intimately concerned with agriculture, agricultural interests should have easy access to any futures regulatory body. However, futures trading must be perceived as unique and must be regulated by its own administrative system.

Notwithstanding the CFTC's informed approach to defining and regulating the markets, the popular perception of futures as primarily agricultural is highly dysfunctional. Perhaps the gravest consequence is that this mistaken notion limits the markets' utility to the general public, which constitutes the vast majority of potential traders.¹⁹ One of the most prominent scandals that precipitated passage of the CFTC Act involved the fraudulent marketing of putative "commodities options."²⁰ These agricultural and nonagricultural options were sold not to hedgers, but to great numbers of average speculators²¹ who sought an alternative vehicle for use of risk capital in light of the depressed condition of the securities markets. CFTC encouragement of greater public participation in futures markets would benefit all who use the market, dispelling the notion that only farmers trade in futures.

SPECULATION: BEARING THE RISKS

The true role of the speculator has also been woefully misunderstood. Commissioner Rainbolt aptly indicates that many provi-

18. The author recommends the discontinuance of the mistaken practice of treating option trades in unregulated commodities as sales of securities. For a discussion of this practice, see Borton & Abrahams, *Options on Commodity Futures Contracts as Securities in California*, 29 BUS. LAW. 867 (1974); Selvers, *Investment Contracts: Expanding Effective Securities Regulation*, 48 ST. JOHN'S L. REV. 525, 539-44 (1974).

19. In 1973, only an estimated 300,000 to 500,000 individuals traded futures. It was estimated that this figure would rise to approximately 5,000,000 by 1980. Few new traders were expected to be professionals. Barron's, May 28, 1973, at 11, col. 1.

20. See Rainbolt, *supra* note 5, at 14. The options involved in the scandal were "naked." Options are naked "where the contract supposedly secured by the option premium was never purchased or margined for future purchase." H.R. REP. NO. 975, 93d Cong., 2d Sess. 48 (1974).

21. Wall St. J., Feb. 21, 1973, at 1, col. 1.

sions of the current law are legacies of the groundless polemics directed at speculators by architects of the 1936 futures legislation.²² As recently as 1973, remarks such as these by Senator George McGovern were not uncommon:

The people's interest in commodity trading transcends the orderly functioning of those markets and the prevention of outright fraud. For every time a speculator turns an unreasonable profit by trading futures, the housewife and the consumer pay the price. And since it is the speculator, not the producer, who receives the windfall profit, the higher wholesale and retail prices do not act as a stimulant to production.²³

Thus, the speculator is frequently viewed as a sinister character. The meaning of "unreasonable profit" is abstruse because, from the standpoint of the dealer with no interest in the underlying commodity itself, futures trading is a purely speculative medium; the speculator must stand to make substantial profits to justify the risk of substantial loss. One cannot invest in futures as he might invest in securities.²⁴ Theoretically, a trader could hold a long or short futures position for approximately eighteen months, the longest life of currently available futures contracts. As a practical matter, however, traders rarely hold a position for more than one or two months. Traders without an interest in the underlying commodity can reap substantial profit or, more probably, bear substantial loss²⁵ in a few minutes.²⁶ If it can be said that profit is "unreasonable" only where it results from illegally distorted prices, then it should follow that the speculator's profits are not unreasonable but are rather a necessary inducement to his participation in the market.²⁷ A noted economist in this field, familiar with the realities of futures trading, recognized the utility—even the neces-

22. Rainbolt, *supra* note 5, at 8.

23. [1973] SEC. REG. & L. REP. (BNA) A-14 (1973).

24. See S. ANGRIST, *SENSIBLE SPECULATION IN COMMODITIES* 14 (1972).

25. Feduniak, *Commodity Futures: Still in Season*, FINANCIAL WORLD, October 15, 1977, at 49; *Chicago's Booming Commodity Markets: Hotter than Wall Street*, U.S. NEWS & WORLD REP., June 13, 1977, at 81.

26. For a thorough discussion of profit and loss potential, see S. KROLL & I. SHISHKO, *THE COMMODITY FUTURES MARKET GUIDE* 77-88 (1973).

27. President Roosevelt stated: "It is my belief that exchanges for dealing in securities and commodities are necessary and of definite value to our commercial and agricultural life. Nevertheless, it should be our national policy to restrict, as far as possible, the use of these exchanges for purely speculative operations." 78 CONG. REC. 2264 (1934) (addressing Congress concerning Securities Exchange Act of 1934), quoted in H.R. REP. NO. 975, 93d Cong., 2d Sess. III (1974).

sity—of the speculator's participation in futures markets: "In every futures transaction, the speculator incurs the duties and acquires the rights of a holder of property and thus is an integral part of commerce. Whether the impact of his activities is 'good' or 'bad' is neither here nor there—they are inevitable and necessary."²⁸

To understand the role of the commodities speculator,²⁹ it is essential to understand his risk-bearing function. While the market performs an insurance function for hedgers,³⁰ market participation is dissimilar to insurance. Insurance eliminates risk by spreading it among many similarly situated participants. On the other hand, futures markets merely transfer risk from hedgers, who wish to avoid it, to speculators, who are willing to bear it and can presumably afford it.

The speculator must bear not only the usual risks inherent in investing, but the additional risks which arise out of certain practices peculiar to commodity futures trading, such as price limits. Although a futures exchange is theoretically a perfect supply and demand marketplace,³¹ in practice it is not, even without intentional, illegal price distortion. Exchange price limits are an important source of market imperfection. Price limits mandate that the price of a given futures contract cannot move more than a prescribed amount from the previous day's closing price.³² Should the price rise or fall that prescribed amount on the opening call, the exchange will halt trading in that contract. Cessation in trading occurs frequently and can last from a few minutes to several days.³³ An example may clarify the operation of limits. Assume trading in January silver closes Monday at \$4.50 per ounce. On Monday evening, some apocalyptically bearish news is released concerning the price of silver. On Tuesday morning, the price of January silver is likely to open at \$4.30, down a representative 20¢ limit. There might be a trade or two at that price, but more likely there will be no trades and only an "ask" price of \$4.30. If, during trading, there

28. T. HIERONYMUS, *supra* note 2, at 140.

29. A speculator is "[o]ne who voluntarily accepts the risks associated with the ownership of a commodity and relies on a price change in the commodity to produce a profit, or risk premium, for his efforts." S. ANGRIST, *supra* note 24, at 205.

30. A hedge is "[a] commitment in the futures market which is established to offset a cash commodity position." *Id.* at 201.

31. T. HIERONYMUS, *supra* note 2, at 98.

32. *Id.* at 38; S. KROLL & I. SHISHKO, *supra* note 26, at 11.

33. In February 1973, soybean futures trading was halted for several days. N.Y. Times, Feb. 27, 1973, at 47, col. 1.

is no mitigation of the bad news, there will be no trading in January silver that day. Outstanding longs will be unable to sell because there are no willing buyers at \$4.30. On Wednesday morning, if there is still no good news, January silver will open at an ask price of \$4.10. On Thursday, it will open at an ask price of \$3.90, and so on, until there is some good news or until the price falls enough to balance demand with supply.

If trader A had bought one 5000 ounce contract of January silver at Monday's closing price of \$4.50, he would have put up the established minimum margin of \$2500, for which he would have owned \$22,500 in silver. At Tuesday's opening, A's silver would be worth only \$21,500. A would have lost \$1000, forty percent of risked capital. This loss would have occurred even if A had been circumspect enough to enter a protective stop-loss order at \$4.40, because trading was not continuous between \$4.50 and \$4.30. In fact, there may have been no trades at all between those levels.

If A had put up no more than the minimum margin requirement of \$2500, he would get a \$1000 margin call Tuesday morning. At Wednesday's opening, a January silver contract would be worth only \$20,500. Then A's loss would be \$2000, eighty percent of margin. In this hypothetical situation, A could never have liquidated his position, even if he had entered a market order to sell every morning, because *no trading was taking place*. A sell order would not and could not be executed. Becoming "trapped" by successive "limit-down" days is quite common. Obviously, if A had been short instead of long, he would have reaped windfall profits.

Since this hypothetical exchange's prescribed limit on silver is 20¢ either way, a day's trading range can be as much as 40¢—20¢ up, then 20¢ down from previous close, or vice versa. Assume that last Friday's close had been \$4.30. By Monday afternoon, January silver was "limit-up" to \$4.50. If trader A then bought before the close at \$4.50, and the apocalyptic news had hit the trading floor after A's purchase but before close, then late Monday afternoon, January silver would go "limit-down" to \$4.10 per ounce. A would have lost eighty percent of his capital in one afternoon or, more likely, in an even shorter time. A never had a chance to liquidate. Although this is an extreme example, similar situations occur frequently in futures markets.

THE TREATMENT OF FUTURES AS SECURITIES

Both speculator and hedger can trade only through an exchange or "contract market." A futures exchange is a nonprofit

membership organization which does not buy or sell futures or set futures prices.³⁴ Exchanges draft and enforce many trading regulations, such as the quality standards for each commodity, the specifications and verbiage of each contract, and the guarantee mechanisms for buyers and sellers. Exchanges also set margin requirements which, with great variation, are currently about ten percent of a given contract value. Futures exchanges perform functions analogous to those performed by securities exchanges. This partially accounts for the inaccurate but not uncommon notion that the two are intrinsically similar.

It is relatively easy to distinguish between futures markets and securities markets. As a practical matter, futures trading is a zero-sum game, that is, one man's profits are another man's losses. If trader *B* buys a contract of December silver at \$4.00, and sells at \$4.50, that 50¢ profit derives from the 50¢ loss on the part of the holder of the short side of that same contract. Thus, in a bullish futures market, there are as many losers as winners, while in a bullish securities market, all participants can make money. This result is partially attributable to the complexity and great risks inherent in selling short in a securities market. But, in futures markets, short-selling is commonplace and no more risky than any other position.³⁵

Despite the significant distinctions, the superficial similarity between the two markets may have partially accounted for the application of securities law concepts to futures markets. Nonetheless, the conventional purchase and sale of commodity futures has been held authoritatively not to constitute a securities transaction.³⁶ Unconventional vehicles related to futures trading, however, such as futures options, discretionary futures accounts, warehouse receipts, and similar items³⁷ have been held to fall

34. For a discussion of exchange functions, see T. HIERONYMUS, *supra* note 2, at 13-14.

35. Short-selling of stock is more risky than the average securities purchase because in short-selling there is no limit to potential loss. In ordinary securities purchases, loss is limited to purchase monies. In futures markets, short-selling is natural and necessary to any purchase.

36. See *Schwartz v. Bache & Co.*, 340 F. Supp. 995 (S.D. Iowa 1972); *Sinva, Inc. v. Merrill, Lynch, Pierce, Fenner & Smith, Inc.*, 253 F. Supp. 359 (S.D.N.Y. 1966). See also *SEC v. Continental Commodities Corp.*, 497 F.2d 516, 520 n.9 (5th Cir. 1974).

37. For a discussion of these unconventional vehicles, see Hodes & Dreyfus, *Discretionary Trading Accounts in Commodities Futures—Are They Securities?*, 30 BUS. LAW. 99 (1974); Selvers, *supra* note 18.

within the purview of the Securities Act of 1933³⁸ and the Securities Exchange Act of 1934.³⁹ After the effective date of the CFTC Act, the Commission made clear its intent to exercise its exclusive jurisdiction in these matters, particularly with respect to options.⁴⁰ Misconceptions concerning the true role of the speculator and the nature and functions of futures, and confusion between securities and futures markets have contributed significantly to certain of today's regulatory problems. There has been similar confusion in defining manipulation as it operates in the futures market, particularly with regard to the vital distinction between speculation and manipulation.

MANIPULATION: MANAGING THE MARKET

Manipulation is another way true supply and demand are distorted. As Professor Hieronymus asserts, a workable definition of manipulation has traditionally eluded authorities.⁴¹ But it is indubitably true, as the court noted in *Cargill, Inc. v. Hardin*,⁴² that "the methods and techniques of manipulation are limited only by the ingenuity of man."⁴³ Since the definition of manipulation has been left to judicial and administrative construction, major cases have produced several interesting differences of opinion concerning what constitutes manipulation.

In *General Foods Corp. v. Brannan*,⁴⁴ the Seventh Circuit adopted the definition, articulated in the prosecution's brief, that manipulation is "the creation of an artificial price by planned action, whether by one man or a group of men."⁴⁵ The case concerned a "corner"⁴⁶ in rye and rye futures by General Foods and others, but the requirement of intent in the Government's defini-

38. 15 U.S.C. §§ 77a-77bbbb (1970 & Supp. V 1975).

39. 15 U.S.C. §§ 78a to 78hh-1 (1970 & Supp. V 1975).

40. See *SEC v. Univest, Inc.*, 410 F. Supp. 1029 (N.D. Ill. 1976) (preempting SEC jurisdiction); CFTC Interpretative Letter No. 76-19, [1975-1977 Transfer Binder] COMM. FUT. L. REP. (CCH) ¶ 20,213 (Sept. 29, 1976) (preemption of state regulation).

41. Hieronymus, *Manipulation in Commodity Futures Trading: Toward a Definition*, 6 HOFSTRA L. REV. 41, 43 (1977).

42. 452 F.2d 1154 (8th Cir. 1971), cert. denied, 406 U.S. 932 (1972).

43. *Id.* at 1163.

44. 170 F.2d 220 (7th Cir. 1948).

45. *Id.* at 231.

46. In a "corner," one trader holds a dominant position in both longs and shorts for a particular futures month, as well as a dominant position in deliverable cash supplies during the same period. J. BAER & O. SAXON, *supra* note 4, at 82-83.

tion caused the conviction below to be reversed.⁴⁷ The court noted that the CEA judicial officer had arbitrarily presumed consciously collusive activity, rather than finding facts to that effect.⁴⁸

In *Volkart Brothers, Inc. v. Freeman*,⁴⁹ the Fifth Circuit held that a "squeeze" does not violate the Commodity Exchange Act unless it is intentional. The difference between a squeeze and corner is esoteric, but the *Volkart* court relied upon an excellent authority in concluding that "[a] squeeze is a relatively small corner, occurring in deliveries for some one month or some one grade. Some—or, in fact, most—squeezes are inevitable on both the physical and the exchange markets and are not the result of illegal manipulation."⁵⁰ In view of the facts, the court decided that the defendant's actions did not constitute manipulation.⁵¹

Under similar factual circumstances, the Eighth Circuit held in *Cargill* that Cargill had intentionally maneuvered a squeeze in the May 1963 wheat contract.⁵² Although presented with little if any direct proof of intent in this case, the court nevertheless found the requisite intent in Cargill's market behavior.⁵³ The court also criticized the *Volkart* opinion as having no regard for economic realities.⁵⁴ The *Cargill* court may have been unaware of a circumstance which readily distinguishes *Cargill* from *Volkart*. In

47. 170 F.2d 220, 231 (7th Cir. 1948).

48. See *id.* at 230-31.

49. 311 F.2d 52 (5th Cir. 1962).

50. *Id.* at 59 (quoting J. BAER & O. SAXON, *supra* note 4, at 82-83). See also Comment, *Manipulation of Commodity Futures Prices—The Great Western Case*, 21 U. CHI. L. REV. 94 (1953); 73 YALE L.J. 171 (1963) (discussion of problems in defining manipulation).

51. *Volkart Bros., Inc., v. Freeman*, 311 F.2d 52, 59-60 (5th Cir. 1962). The court in *Volkart* reached this conclusion despite these traders' controlling long position on the exchanges, the insufficient supply of the commodity available to shorts for delivery, and the establishment of artificially high prices by the traders in liquidation of futures contracts. See *id.*

52. *Cargill, Inc. v. Hardin*, 452 F.2d 1154, 1172 (8th Cir. 1971), *cert. denied*, 406 U.S. 932 (1972). See 57 MINN. L. REV. 1243, 1243-44 (1973).

53. See *Cargill, Inc. v. Hardin*, 452 F.2d 1154, 1170-72 (8th Cir. 1971), *cert. denied*, 406 U.S. 932 (1972).

54. See *id.* at 1172-73. The court found that Cargill had had a dominant position in cash supplies, whereas in *Volkart Bros., Inc. v. Freeman*, 311 F.2d 52 (5th Cir. 1962), there was no question that the defendant corporation had negligible cash commitments. This distinction requires a consideration of the terms "corner," and "squeeze." The question of which wheat supplies were available was also resolved against Cargill, which had argued that Kansas City wheat was available and therefore deliverable against Chicago futures contracts. This availability question is highly complex, focusing ultimately on the difference between cash and futures prices. See T. HIERONYMUS, *supra* note 2, at 152-66.

Cargill defendant corporation had markedly greater control of both the long futures positions outstanding on the expiration date of the May contract and the available physical supplies of wheat in nearby cash markets.⁵⁵ It is unclear whether the court realized the importance of this distinction.

Despite the different facts in these two cases and the inconsistency of their rules, one element is common to all manipulation cases of this general type: The alleged manipulator could not accomplish his purpose unless he eventually had *some* position in the cash market. True speculators, with few if any exceptions, cannot be manipulators.⁵⁶ The type of manipulation at issue here is that of commodity price, not necessarily futures price. If we define the general type of malfeasance discussed above as cornering and squeezing manipulation, an examination of one recently alleged corner, the so-called "Maine potato scandal"⁵⁷ will support the notion that a true speculator, who never has any interest in the underlying commodity, virtually cannot corner or squeeze a market. If speculation does not seriously distort commodity prices, there is

55. Also relevant to manipulation cases is the method used by courts to measure market manipulation. Courts measure the theoretical differential against the actual differential between cash and futures prices. In *Cargill* the court accepted the four tests proposed by the Government to determine whether the futures price was artificial, thus evidencing manipulation. *Cargill, Inc. v. Hardin*, 452 F.2d 1154, 1167-70 (8th Cir. 1971), *cert. denied*, 406 U.S. 932 (1972). Three of these tests compared, from an historical perspective, the particular wheat futures contract price with the prices for the preceding nine years on the Chicago Board of Trade. However, the fourth test analyzed whether this futures price bore a proper relationship to the price of cash wheat at that time. This test's application postulated that the price of the future should be 2½¢ to 3¢ less than "spot," the price of cash wheat which reflects warehousing costs. On this basis, the court concluded that the futures price was artificially high. This is a dangerous presumption, since there are numerous possible causes of distortion between cash and normal futures prices that do not reflect manipulation. See note 15 *supra* and accompanying text; T. HIERONYMUS, *supra* note 2, at 171-72.

56. T. HIERONYMUS, *supra* note 2, at 338, notes that market dominance by a large speculator should be avoided, and that there are certain extraordinary situations where the sheer size of a speculative position may have deleterious consequences. See *Breaking the Hunts' Grip on Soybeans*, BUS. WEEK, May 16, 1977, at 40-41, detailing a recent CFTC allegation which remains unresolved as of this writing. The CFTC here alleged manipulation by a family of traders which held more than seven times the speculative position limit in soybean futures. The allegation, which apparently did not reflect the industry view on the question, was made prior to any known cash dealings by the Hunts in soybeans. *Id.*

57. This scandal involved a massive default in delivery against the May 1976 potato futures contract on the New York Mercantile Exchange. In this, perhaps the largest manipulation ever attempted through a contract market, virtually no speculators were involved. See *How Jack Simplot, Other Big Traders, Waged a Potato War*, Wall St. J., June 1, 1976, at 1, col. 1.

support for Professor Hieronymus's suggestion that speculative position limits should be eliminated.⁵⁸ Large-scale speculators benefit futures markets and limits are detrimental to their interests.

There are many types of manipulation.⁵⁹ Some involve questionable practices on the exchange floor, such as the "dual trading" capability of futures floor brokers.⁶⁰ The CFTC has addressed this issue,⁶¹ however, and is moving toward the firm control of this "floor" manipulation. Insider trading is a more general type of manipulation which has not been subject to extensive CFTC concern. This lack of concern arises from a superficial, confusing comparison of futures insider trading with its securities counterpart. The substantive rules concerning insider trading that have developed in federal securities law are only conceptually relevant to futures insider trading questions. The CFTC has dealt only with the most narrow concept of insider trading, by prohibiting under threat of criminal prosecution the use of information by insiders who are commissioners, employees, or agents of the CFTC. Underlying both the securities and the corporate regulatory posture is the common law principle of fiduciary duty.⁶² It would seem clear that the grain company president who confidentially learns of an impending "Russian wheat deal"⁶³ and trades for his own account based on such inside information operates to the detriment of the market. Such trading falsifies prices and defrauds those who take the opposite side of his transactions. Unfortunately, it is difficult to reach his conduct by any stretch of the common law fiduciary duty theory. Although it is possible that a broad antifraud regulation might discourage insider trading, the development of specific regulations to deal directly with the abuse would be more effective. A wholly new solution is required to regulate effectively insider trad-

58. See Hieronymus, *supra* note 41, at 54-56.

59. See *id.* at 45-50.

60. "Dual trading" refers to a floor broker's capacity to trade for his own as well as other accounts; such trading enlarges the possibility of a particularly devious kind of manipulation. See *Hearing Before the Subcomm. on Small Business Problems of the House Permanent Select Comm. on Small Business*, 93d Cong., 2d Sess. 160-63 (1974) [hereinafter cited as *Small Business Hearing*]; T. HIERONYMUS, *supra* note 2, at 342-44.

61. See 40 Fed. Reg. 58,660 (1975), reprinted in [1975-1977 Transfer Binder] COMM. FUT. L. REP. (CCH) ¶ 20,118 (1975) (proposed regulation regarding dual trading).

62. See, e.g., *Brophy v. Cities Serv. Co.*, 31 Del. Ch. 241, 70 A.2d 5 (1949); *Diamond v. Oreamuno*, 24 N.Y.2d 494, 248 N.E.2d 910, 301 N.Y.S.2d 78 (1969).

63. See generally *Small Business Hearing*, *supra* note 60, at 377.

ing in futures markets. Securities treatment of the problem is relevant only to perception of the issue, not to its control. Certain distinctions which are irrelevant to securities insider trading, such as that between speculating and hedging, might well be useful in determining who has futures information that is truly "inside." Logically, those who deal daily in the underlying commodity would be more likely to learn useful information than those who deal exclusively in futures.

CONCLUSIONS AND SUGGESTIONS

This article has attempted to explain futures markets, to define the role of the speculator, to describe manipulation in commodities markets, and to indicate certain regulatory problems which remain to be solved.

The average speculator in today's futures market may once have been the average investor protected by securities legislation. In recent years, many securities investors became disillusioned with the stock market, and viewed commodity futures as a new vehicle for using limited risk capital. Thousands of these average traders sought entry into futures by means of "naked" options in the early 1970's; they were lavishly defrauded.⁶⁴ With the advent of the CFTC, such traders may rightly expect adequate protection. Examining certain common misconceptions about futures would further an accurate understanding of certain fundamentals and aid in determining the proper regulation of major abuses.

The foregoing analysis suggests certain conclusions. First, the CFTC should recognize that it has two separate regulatory constituencies: speculators who deal only in futures, who are vital to the markets, and hedgers, who deal regularly in the commodity itself and for whom the markets are vital. The ideal regulatory posture would take into account this distinction,⁶⁵ particularly as it relates to the definition and treatment of manipulation and to the imposition of exchange limits.

Second, both large and small speculation should be encouraged in an orderly fashion. This could be accomplished by large-scale

64. See Rainbolt, *supra* note 5, at 14.

65. T. HIERONYMUS, *supra* note 2, at 328-29, suggests that speculation and hedging are very similar processes based on risk exposure. While this notion may be correct, the terms are used here to attempt to classify *persons*, not transactions. This classification is more useful in analyzing, for example, the requisite intent for a finding of manipulation.

dissemination of information and establishment of an options program,⁶⁶ as well as by regulations designed generally to protect the average trader from abuse. Encouragement is necessary, since the recent scandals and the enormous risks to which speculators are exposed are natural disincentives to market entry.

Third, regulation should reflect the essential differences in the underlying nature of commodities markets. No future is an agricultural item, but futures contracts that deal with agricultural products should be recognized as involving a unique set of problems. The CFTC could regulate agriculturally based markets with a view toward the needs of those markets, their hedgers, and their speculators. Since many agricultural markets operate only in the United States, there should be a difference between regulating domestic corn markets and regulating the worldwide markets in gold and silver. While there have been corners or squeezes in gold and silver, it is difficult to conceive of a successful corner in certain of the financial markets, in foreign currencies, or in Treasury bills.

Finally, securities markets and securities laws should be relegated to their proper position in relation to futures markets and futures regulations. Securities laws are analogous, but should not be dispositive. The distinction between the two requires further elucidation. Recently, the CFTC has come under severe attack⁶⁷ on a number of grounds; suggested remedies have included a return of authority over futures regulation to the USDA.⁶⁸ It has been demonstrated that this return of authority would be wholly inadequate. Whatever the problems of the fledgling, understaffed Commission, a more realistic regulatory approach furthering the expeditious opening of the markets to all potential traders would benefit the speculator, the industry, and the Commission. The average trader wishes to, and undoubtedly will eventually, enter these markets. The CFTC must energetically police, and perhaps redevelop "the badlands of the commodity market."⁶⁹

66. See, e.g., 41 Fed. Reg. 51,808 (1976), reprinted in [1975-1977 Transfer Binder] COMM. FUT. L. REP. (CCH) ¶ 20,236 (1976) (regulations of commodity option transactions).

67. See *The Futures Regulator Comes Under Fire*, BUS. WEEK, August 15, 1977, at 97.

68. See *id.*

69. *Hecht v. Harris Upham & Co.*, 283 F. Supp. 417, 435 (N.D. Cal. 1968).