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ON BEING REGULATED: REMARKS BY A FUTURES COMMISSION MERCHANT

*Stephen Greenberg**

In October 1974, Congress adopted sweeping amendments¹ to the Commodity Exchange Act² (the CEA). These amendments, known as the Commodity Futures Trading Commission Act of 1974, established the Commodity Futures Trading Commission³ (CFTC) and extended federal regulation from specific items, primarily domestic agricultural products,⁴ to all transactions involving future deliveries of commodities.⁵ The 1974 amendments also broadened regulation of commodity trading professionals. It expanded regulation of futures commission merchants (FCMs)⁶ and floor brokers,⁷ and initiated registration requirements for three new professional groups: associated persons,⁸ trading advisors,⁹ and commodity pool

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1. Commodity Futures Trading Commission Act of 1974, Pub. L. No. 93-463, 88 Stat. 1389 (codified at 7 U.S.C. §§ 2-22 (Supp. V 1975)).

2. 7 U.S.C. §§ 1-22 (1970 & Supp. V 1975) (as amended).

3. *Id.* § 4a (Supp. V 1975).

4. *Id.* § 2 (1970).

5. *Id.* § 2 (Supp. V 1975).

6. *Id.* §§ 6d, 6f, 6g, 6j(2), 6p. *Id.* § 2 provides in pertinent part:

The words "futures commission merchant" shall mean and include individuals, associations, partnerships, corporations, and trusts engaged in soliciting or in accepting orders for the purchase or sale of any commodity for future delivery on or subject to the rules of any contract market and that, in or in connection with such solicitation or acceptance of orders, accepts any money, securities, or property (or extends credit in lieu thereof) to margin, guarantee, or secure any trades or contracts that result or may result therefrom.

7. *Id.* §§ 6e, 6f, 6g, 6j(1), 6p. *Id.* § 2 provides in pertinent part:

The words "floor broker" shall mean any person who, in or surrounding any "pit", "ring", "post", or other place provided by a contract market for the meeting of persons similarly engaged, shall purchase or sell for any other person any commodity for future delivery on or subject to the rules of any contract market.

8. *Id.* § 6k, 6p. An "associated person" is a professional who handles customer accounts for futures commission merchants (FCMs) or agents of FCMs. *Id.* § 6k.

9. *Id.* §§ 6m, 6n, 6o. *Id.* § 2 provides in pertinent part:

The term "commodity trading advisor" shall mean any person who, for com-

operators.¹⁰

The purpose of these remarks is to examine the responsibilities of commodity trading professionals within the context of the CEA. This will be accomplished by discussing the impact of the relevant CEA provisions on the various commodity professionals and examining remaining problems and possible remedies.

Federal regulation of commodity professionals is largely achieved through CEA-mandated registration requirements. FCMs and associated persons constitute the broadest group subject to registration requirements. An FCM must register with the CFTC prior to soliciting or accepting orders for commodity futures contracts.¹¹ It must also furnish information pertinent to the operation of the business, including names and addresses of those engaged in solicitation or acceptance of contract orders, and the names of partners if the FCM is a partnership, or if it is a corporation, the names of its officers, directors, and stockholders.¹² A business seeking FCM status must meet minimum financial requirements and must continue to maintain those standards.¹³

pensation or profit, engages in the business of advising others, either directly or through publications or writings, as to the value of commodities or as to the advisability of trading in any commodity for future delivery on or subject to the rules of any contract market, or who for compensation or profit, and as part of a regular business, issues or promulgates analyses or reports concerning commodities; but does not include (i) any bank or trust company, (ii) any newspaper reporter, newspaper columnist, newspaper editor, lawyer, accountant, or teacher, (iii) any floor broker or futures commission merchant, (iv) the publisher of any bona fide newspaper, news magazine, or business or financial publication of general and regular circulation including their employees, (v) any contract market, and (vi) such other persons not within the intent of this definition as the Commission may specify by rule, regulation, or order: *Provided*, That the furnishing of such services by the foregoing persons is solely incidental to the conduct of their business or profession.

10. *Id.* §§ 6m, 6n, 6o. *Id.* § 2 provides in pertinent part:

The term "commodity pool operator" shall mean any person engaged in a business which is of the nature of an investment trust, syndicate, or similar form of enterprise, and who, in connection therewith, solicits, accepts, or receives from others, funds, securities, or property, either directly or through capital contributions, the sale of stock or other forms of securities, or otherwise, for the purpose of trading in any commodity for future delivery on or subject to the rules of any contract market, but does not include such persons not within the intent of this definition as the Commission may specify by rule or regulation or by order.

11. *Id.* § 6d(1).

12. *Id.* § 6f(1). Those engaged in solicitation or acceptance of contract orders include "the managers of all branch offices and of all correspondents and agents" *Id.*

13. *Id.* § 6f(a).

Furthermore, associated persons must register with the CFTC if they solicit, accept,¹⁴ or supervise solicitation and acceptance of customer orders.¹⁵ In addition, while registration by pool operators and trading advisors may appear at first glance to be optional,¹⁶ in practical terms, those two groups must register; they must register prior to using the postal service or engaging in transactions involving interstate commerce.¹⁷ The CEA, through its registration provisions, has brought more than 23,000 individuals under federal regulation.¹⁸

The CEA makes additional demands of commodity professionals. FCMs are closely regulated in their handling of customer funds. The CEA requires FCMs to maintain separate accounts and to perform daily accountings for each customer's funds.¹⁹ This segregation and accounting is required to assure that the FCM does not convert customer funds to his own use and to assure that sufficient funds are always available to meet customer obligations. As such, it is one of the strongest protective devices mandated by the CEA.

Registered FCMs are subject to stringent recordkeeping and reporting requirements. They must maintain records of daily trading activities²⁰ and retain them for five years for possible CFTC inspection.²¹ The recordkeeping and reporting requirements are prime customer protection and surveillance tools. These requirements permit the CFTC to reconstruct trading activity and to determine if an FCM placed his own orders prior to client orders and whether client orders were entered in an efficient and timely manner. Additionally, these requirements enable the CFTC to study overall market activity both to detect market manipulation and to ascertain whether speculators' activities had an undue influence on price.

The CFTC has conferred weighty responsibility upon commodity professionals to prevent unfair handling of public orders.

14. *Id.* § 6k(1)(i).

15. *Id.* § 6k(1)(ii).

16. *Id.* § 6n(1) states that these groups "may register . . ." (emphasis added).

17. *Id.* § 6m.

18. COMMODITY FUTURES TRADING COMMISSION ADVISORY COMM., REPORT ON COMMODITY FUTURES TRADING PROFESSIONALS 3 (1976).

19. 7 U.S.C. § 6d(2) (separate accounts); *id.* § 6g(3) (daily accountings).

20. *Id.* § 6g(3).

21. *Id.* § 6g(4) requires that records be maintained "for such period as may be required by the Commission." 17 C.F.R. § 1.31 (1977) specifies this period as five years.

For example, regulation 155.3 requires each FCM to establish and enforce internal rules and procedures to assure that each order is handled in a manner consistent with the client's best interest.²² In addition, the CEA and CFTC regulations prohibit actions which would result in fraud; FCMs,²³ pool operators, and trading advisors²⁴ are barred from disseminating false and misleading information.

In recent years, activity in the commodities industry has increased dramatically. Consequently, the public now focuses greater attention on the futures markets. Thus, the number of trading advisors, pool operators, and FCMs has grown. Because of that growth, and in anticipation of further activity, the CFTC will probably place more rigid requirements on commodity trading professionals. The purpose of this action would be to provide maximum protection to the public, to aid public understanding of the purposes of futures markets, and to raise public confidence in these markets.

In fact, the CFTC has proposed rules specifically "designed to protect, in various respects, members of the public who deal with commodity trading professionals."²⁵ The proposed rules fall into seven broad categories: (1) Suitability—Each commodity professional would be required both to determine his customer's financial situation and trading objectives and to advise the customer in a manner consistent with that determination;²⁶ (2) Supervision—Each commodity firm would be required to exercise careful supervision of its employees;²⁷ (3) Risk Disclosure—Commodity brokerage firms would be required to explain to each customer the risk of loss inherent in commodity futures trading;²⁸ (4) Discretionary Accounts—These rules would limit the conditions under which professionals could trade on behalf of customers with discretionary

22. 17 C.F.R. § 155.3 (1977). This regulation requires that customer orders be entered prior to the entering of any proprietary order for an FCM or an affiliated person. Moreover, it prevents affiliated persons from placing orders directly or indirectly with another FCM in a manner which would be designed to circumvent the provisions of this general rule. The regulation further precludes FCMs or any of their affiliated persons, under certain circumstances, from disclosing the nature of an order being held on behalf of a client. In general, it is intended to assure the fair and equitable handling of public orders handled by professionals in the trade.

23. 17 C.F.R. §§ 30.02-.03 (1977).

24. 7 U.S.C. § 6o (Supp. V 1975).

25. 42 Fed. Reg. 44,741, 44,742 (1977).

26. *Id.* at 44,743-45.

27. *Id.* at 44,746-47.

28. *Id.* at 44,747-48.

accounts;²⁹ (5) Advertising—Professionals would be prohibited from advertising performance based on simulated or hypothetical accounts.³⁰ The remaining areas of the proposed rules deal with standards for (6) handling customer orders and trading activities³¹ and (7) recordkeeping.³²

Furthermore, the CFTC should adopt regulations requiring minimum financial standards for all FCMs. While most FCMs are members of commodity exchanges and subject to their self-regulatory capital requirements, capital standards for nonexchange member FCMs are desirable; the resulting industry uniformity would be beneficial. The industry could also strengthen standards by forming a self-regulatory association.

More stringent requirements may be placed on FCMs in the areas of risk disclosure, customer protection, competency examinations, minimum financial standards, and auditing of FCMs' financial statements. Associated persons and FCMs may become more closely regulated with respect to their personal trading activities.

Commodity pool operators should expect rules and regulations requiring more stringent standards for pool operation, recordkeeping, segregation of customer funds, and self-dealing. They may be further required to report periodically to pool participants.

Commodity trading advisors should expect new regulations which will govern their activities more closely. It is not anticipated that financial standards will be imposed on trading advisors. Yet, disclosure of the risks in futures trading, and of a trading advisor's affiliation with any FCM whose services he recommends probably will be required.

The rapid growth of the commodities industry and the increased public participation in commodity futures markets during the last decade has resulted in expanded self-regulation by the organized American commodity exchanges. Commodity pool operators, commodity trading advisors, and nonexchange FCMs, however, have not been subject to similar self-regulation. The CFTC should promulgate further rules which place greater responsibility on all FCMs, associated persons, pool operators, and trading advisors to assure that the public is afforded the safeguards necessary when dealing with commodity professionals.

29. *Id.* at 44,746. A discretionary account affords the FCM power of attorney to trade the client's account in the client's best interest.

30. *Id.* at 44,748.

31. *Id.*

32. *Id.*

