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SYMPOSIUM ON COMMODITY FUTURES REGULATION

REGULATING THE GRAIN GAMBLER AND HIS SUCCESSORS

John V. Rainbolt, II*

People will endeavor to forecast the future and to make agreements according to their prophecy. Speculation of this kind by competent men is the self-adjustment of society to the probable. Its value is well known as a means of avoiding or mitigating catastrophes, equalizing prices and providing for periods of want. It is true that the success of the strong induces imitation by the weak, and that incompetent persons bring themselves to ruin by undertaking to speculate in their turn. But legislatures and courts generally have recognized that the natural evolutions of a complex society are to be touched only with a very cautious hand, and that such coarse attempts at a remedy for the waste incident to every social function as a simple prohibition and laws to stop its being are harmful and vain.¹

—MR. JUSTICE HOLMES

It is an appropriate time for the Editors to assemble this Symposium on Commodity Futures Regulation. It falls on the eve of

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congressional review of the Commodity Exchange Act and at a time when, according to the Futures Industry Association, the regulated futures industry has first exceeded an annual trading “value” of $1 trillion.

Since 1974, the United States commodities industry has experienced marked growth in size and scope. This growth has been accompanied by a major expansion of the community of interests subject to federal regulation, primarily the result of the Commodity Futures Trading Commission Act of 1974 (the 1974 amendments). This legislation amended the Commodity Exchange Act, transferring federal regulatory authority over futures markets from the Department of Agriculture to the Commodity Futures Trading Commission (CFTC), a new, independent federal regulatory commission. The 1974 amendments also brought domestic futures

2. 7 U.S.C. §§ 1-22 (1970 & Supp. V 1975). Section 12(d) of the Commodity Exchange Act, 7 U.S.C. § 16(d) (Supp. V 1975), is a “sunset” provision, requiring periodic congressional renewal of the agency programs established by that Act. This provision states: “There are hereby authorized to be appropriated to carry out the provisions of this chapter such sums as may be required for the fiscal year ending June 30, 1975, for the fiscal year ending June 30, 1976, for the fiscal year ending June 30, 1977, and for the fiscal year ending June 30, 1978.” Id.

3. FUTURES INDUSTRY ASSOCIATION INC., BULL. No. 2859, ESTIMATED “VALUE” OF COMMODITIES TRADED 1976-1977 (1977). This bulletin stated:

The estimated dollar value of commodities traded is derived from the average unit price at which that commodity traded during the period reported and represents, for comparison purposes only, one measurement of the value of the respective commodities underlying the futures contracts. The estimated dollar value of commodities traded does not represent the monetary value of futures contracts nor cash participation on the futures markets.

Id. This estimated dollar value is, however, a slightly misleading measure of industry size and growth. First, it is a theoretical figure that assumes delivery on all futures contracts traded, even though delivery is actually made on only a small percentage. Second, it reflects such inflationary “values” as trading in the Chicago Mercantile Exchange’s $1 million Treasury bill contract and fails to include any value for domestic options transactions, unfortunately not presently traded on any domestic exchange.

4. Since 1974, a $100 million to $200 million-a-year industry in commodity options has developed in the United States. Futures trading volume and value have increased from approximately 27.7 million contracts and $571.6 billion in 1974 to approximately 41.5 million contracts and $1.1 trillion for July 1, 1976 to June 30, 1977. For a detailed presentation of data, see FUTURES INDUSTRY ASSOCIATION INC., BULL. No. 2859, ESTIMATED “VALUE” OF COMMODITIES TRADED 1976-1977 (1977); FUTURES INDUSTRY ASSOCIATION INC., BULL. No. 2855 (1975); ASSOCIATION OF COMMODITY EXCHANGE FIRMS, INC., BULL. No. 1564 (1975); ASSOCIATION OF COMMODITY EXCHANGE FIRMS, INC., BULL. No. 1563 (corrected) (1975).


trading in certain commodities, various market professionals, commodity option trading, and transactions in gold and silver leverage contracts under strong, exclusive federal regulation for the first time.

The effect of expanding federal regulation in a growing industry has been, in a word, dynamic. In June 1974, the Commodity Exchange Act was applicable to only 1,923 individuals and firms registered with the Department of Agriculture. In November 1977, over 36,000 individuals and firms were regulated by the CFTC. Encompassing such diverse interests as floor brokers, futures commission merchants, trading advisors, pool operators, and options dealers, this volatile community—"volatile and esoteric" according to the House of Representatives—with its incredible complex of trading instruments in over forty active commodities, is impressive to observer and participant alike as it identifies new trends and attendant needs in a troubled economic climate.

This commodities law Symposium brings together some of the best talent in the legal and economic fields to write on subjects of their choosing. The commodities markets are concerned with economics: Their existence allows for the reduction of risk in the production and sale of commodities and improves the allocation of resources through a more efficient system of price information.

15. During September 1977, futures contracts in 40 different commodities were traded on 10 United States exchanges. Futures Industry Association Inc., Bull. No. 2939, Futures Contracts Traded September 1977 (1977). Futures trading in zinc has been approved by the CFTC and is expected to begin in February 1978.
Thus, the Symposium includes economic as well as legal analysis. The strength of the Symposium is that it includes subjects as enduring and fundamental to the marketplace as supply and demand, as well as subjects that may prove more topical and technical when viewed against the inevitable evolution of the institution.

Both the economics and the regulation of commodities trading involve a substantial amount of tradition. Economically, futures and commodity options evolved from cash forward contracts.\textsuperscript{16} Legally, federal commodities regulation reflects the imprint of government's changing perception of its regulatory role as it searches for solutions to problems stemming from changing markets and new participants. As new statutory language is added and as new topics are addressed by successive Congresses, older provisions are not necessarily erased. The Commodity Exchange Act, viewed this way, is a chain letter, first penned in 1921.

**REGULATION OF COMMODITIES MARKETS**

Commodities trading and regulation are not confined to the United States. Historically, the relationship between the industry and governments has been troubled. Both foreign and domestic governments have occasionally banned the very institution of futures trading in some commodities. For example, in 1869, the Imperial Japanese Government banned the *cho-ai-mai* rice ticket market,\textsuperscript{17} and more recently, in 1958, the United States Congress banned futures trading in onions when it was suspected that the price had been manipulated.\textsuperscript{18} Options on certain named commodities were also banned by Congress in 1936.\textsuperscript{19}

In other cases, governmental attitudes toward the futures in-

\textsuperscript{16} A forward contract is an agreement between two parties to deliver and make payment for a designated commodity or service at a designated future date. Futures contracts are forward contracts traded under the bylaws of an organized commodity exchange. The delivery terms and methods of trading by futures contracts are highly standardized. See A. Paul, R. Heifner, & J. Helmuth, U.S. Dep't of Agriculture, Economic Research Service, Report No. 320, Farmers' Use of Forward Contracts and Futures Markets at iv (1976).

\textsuperscript{17} This market, founded in the seventeenth century, is sometimes regarded as the first organized futures market in the world. It was not, however, officially recognized by the Imperial Japanese Government until 1730. See R. Teweles, C. Harlow, & H. Stone, The Commodity Futures Game 8 (1974).


Industry have been more tolerant. Commodity exchanges in London still operate in an environment in which government controls are typically understated, although not necessarily ineffective. The London marketplace, however, is generally dominated by knowledgeable commercials who can protect themselves; on London markets, unlike those in the United States, little activity is attributable to small speculators.

Commodity speculation is a phenomenon that has occasionally reached manic proportions. In such cases, speculators seem akin to lemmings. If there is a role for government at such times, it may amount to little more than observing the proceedings. An early example can be found in the Dutch Government’s dilemma during the extraordinary, frenzied speculation in tulip bulbs that swept Holland in the early 1600’s. As the fad gained momentum, central markets for the sale of bulbs were set up on stock exchanges. Under the auspices of investment clubs, “futures” markets, each with its own rules, sprang up at popular taverns around the country. As tulip bulb prices soared at the height of this feverish speculation, tools were sold, jewels were pawned, and houses were mortgaged to pay for the bulbs. Although laws were passed to regulate the markets, they apparently did little either to diminish the feverish speculation running rampant at the time or to prevent thousands of people from going bankrupt when the bubble burst on February 3, 1637. At best, the laws may have helped to make this unique phenomenon a bit more orderly.

Attempting to identify the proper relationship between the commodities trading complex and government is a constant process. That process has been most visible and important in the United States due to the market forces involved, the number, nationality, and diversity of participants, and the size of the professional body serving those participants. This is exemplified by the upcoming congressional review of the government-industry relationship that has evolved as a result of the CFTC's regulation of national commodity markets over the last three years.  

20. For a discussion of this episode, see Berger, “Tulipomania” Was No Dutch Treat to Gambling Burghers, 8 SMITHSONIAN 1, 70-76 (1977).

21. See note 2 supra and accompanying text.
REGULATION IN THE UNITED STATES

Organized commodity futures trading began in the United States during the middle of the nineteenth century.\(^{22}\) The interaction between two competing economic forces in the 1870's and 1880's led to the first congressional attempt to regulate futures trading. The forces were represented by two groups: traders on commodity exchanges who staunchly supported free markets, defending commodity speculation, and agricultural producers who felt victimized by the marketing philosophies espoused by the first group. Sentiment was with the producers, who had great strength in state legislatures and Congress. The United States was entering the “golden years” of populism.

As a result, several state legislatures, primarily in the South, enacted statutes which equated futures with gambling contracts. For example, in the early 1880's, futures were outlawed in Mississippi\(^{23}\) and considered illegal gambling contracts in Arkansas and Tennessee.\(^{24}\)

The attempt by several members of Congress to pass the Hatch Act\(^{25}\) in 1893 also reflected this perception of futures trading as a threat to the agricultural producer. The Hatch Act was the first major federal effort to control futures trading, but it never became law. The First World War and its attendant economic restrictions temporarily abated the antispeculative forces prevalent in the country. After the war, however, farm prices plummeted. Much of the blame for the depressed prices was directed toward speculators. The practice of speculative short-selling was particularly criticized.\(^{26}\)

Chicago, with its Board of Trade, was looked upon as a gambling hell. Hear Senator Capper in 1921:

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\text{[I]t is against the law to run a gambling house anywhere within the United States. But to-day under the cloak of business responsibility, we are permitting the biggest gambling hell in the world to be operated on the Chicago Board of Trade. . . . The extent and completeness of its system for rounding up suckers explains how the Chicago Board of Trade must “sell” more grain every year than the entire globe produces. . . . [T]he small}
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\(^{23}\) Act of March 7, 1882, 1882 Miss. Laws 140.
\(^{25}\) H.R. 7845, 52d Cong., 1st Sess., 23 CONG. REC. 2910 (1892).
\(^{26}\) See 61 CONG. REC. 4765 (1921) (remarks of Senator Capper).
gambler in futures has no more chance to win than the small gamester in a gambling house where they use marked cards and loaded dice.\textsuperscript{27}

If the farmer is to survive, said Senator Capper, “the grain gambler must go.”\textsuperscript{28}

Senator Capper, a leader of the farm bloc in Congress, proposed a solution to the suicides and crimes that he said had resulted from speculation: the Capper-Tincher bill, which Congress passed as The Future Trading Act.\textsuperscript{29} In addition to its other provisions, this Act levied a tax of twenty cents per bushel on transactions conducted off a designated exchange. A year after enactment, however, the law was declared an unconstitutional exercise of congressional taxing power.\textsuperscript{30} A hasty rewrite of The Future Trading Act, stripped of the taxing provision and containing recitations relating to the effect of futures trading on interstate commerce, was enacted as The Grain Futures Act.\textsuperscript{31} A challenge to the constitutionality of the new Act was unsuccessful.\textsuperscript{32}

The new law regulated futures trading only in grain. The legislation affected the grain exchanges in Chicago, Minneapolis, Kansas City, Duluth, St. Louis, Toledo, Milwaukee, San Francisco, Los Angeles, and Baltimore.\textsuperscript{33} It did not regulate domestic exchanges

\textsuperscript{27} Id. at 4763.
\textsuperscript{28} Id. at 4768. More fully, Senator Capper stated:
We can not expect to gather grapes from thistles. So long as this juggling of the markets is permitted, and so long as this cancer of gambling in one of the necessities of life is permitted, we can not expect to have permanent prosperity in the United States. For years previous to the present crisis in the agricultural industry the men frequently referred to by orators as the “backbone of the Nation” have averaged barely more than a decent living by working their wives and children as well as themselves, and have realized no return from their capital. The real job we have on our hands is to find out how farming can be made as safely profitable as any other American occupation. Unless that can be done it is simply a question of time when our farmers will be forced to abandon a too hazardous means of livelihood. The one vital industry on which the Nation’s welfare and prosperity depend, must have its chance to live and prosper if the rest of us expect to, and if it is to have this chance, the grain gambler must go.

\textit{Id.}

\textsuperscript{29} Ch. 86, 42 Stat. 187 (1921).
\textsuperscript{32} See Board of Trade v. Olsen, 262 U.S. 1 (1923).
\textsuperscript{33} The Chicago Board of Trade, the Minneapolis Grain Exchange, and the Kansas City Board of Trade are the only exchanges still active which were regulated by The Grain Futures Act.
trading in cotton, metals, or international soft commodities, such as coffee and sugar.

This origin of federal commodity exchange regulation is important today for two historical reasons. First, it reflects a system of regulation separate from and antecedent to the system developed for federal regulation of the securities industry, an industry with which the commodities industry is popularly linked. Agricultural futures were, and still are, viewed primarily as adjuncts to the marketing of agricultural commodities. Second, many of the provisions in today's law are legacies both of Senator Capper's attack on speculators and of the system envisioned for their control.

Irrespective of its origin, The Grain Futures Act was thin gruel. Beginning in 1925, successive Secretaries of Agriculture recommended expansion of regulatory powers under the Act. In 1934, the Roosevelt administration called for better regulation in both the commodities and securities industries by proposing the elimination of "unnecessary, unwise, and destructive speculation."
Regardless of the thrust of the presidential message, the image of speculators—the bane of Senator Capper's farmers—became more respectable in the Commodity Exchange Act, Congress' response to the President's call. Less than fourteen years after passage of The Grain Futures Act, the House Committee indicated that at least a few speculators had become "that class of citizens who have a fondness, and perhaps some aptitude, for speculative investment in commodities and who like to test their judgment concerning values and price trends by occasional and moderate speculation therein."  

The Commodity Exchange Act (the 1936 Act) made several changes in the existing regulatory structure. It added cotton and other domestic agricultural commodities to the system of federal regulation. It also conferred new power on the Secretary of Agriculture to regulate exchanges. New burdens were placed on exchanges and also on brokerage houses (futures commission merchants), which were required by the 1936 Act to register with the Secretary. The 1936 Act made it unlawful to cheat, bucket orders, defraud, or deceive customers. Wash sales, "puts," and

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is true, often taken steps to correct certain obvious abuses. We must be certain that abuses are eliminated and to this end a broad policy of national regulation is required.

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.

I therefore recommend to the Congress the enactment of legislation providing for the regulation by the Federal Government of the operations of exchanges dealing in securities and commodities for the protection of investors, for the safeguarding of values, and, so far as it may be possible, for the elimination of unnecessary, unwise, and destructive speculation.

Id.
“calls” were banned. Although speculative limits were authorized, in effect, the community protected under federal commodities law was expanded to include speculators. Although cotton and the other newly designated commodities were now subject to this system of regulation, many commodities traded on United States exchanges were still not part of the federally regulated structure.

What was that regulatory structure?
The 1936 Act only regulated certain named commodities. This specificity arose out of political reality. These commodities and their marketing systems were the farmers’ greatest concerns. In addition, the regulatory structure required exchanges to be “designated” as “contract markets” in individual commodities, floor brokers and futures commission merchants to be registered, and customer funds to be segregated. Manipulation of futures and underlying cash commodities became a misdemeanor. The Department of Agriculture was empowered to investigate reported violations of the 1936 Act, but its remedial powers were still limited to obtaining “cease and desist” orders, suspending or withdrawing exchange designations, and denying trading privileges.

The cash market implications of this regulatory system are also worthy of study. Exchanges today, with the exception of those in Kansas City and Minneapolis, have lost many aspects of the central cash markets with which commodity exchanges were originally associated. These cash markets were subject to manipulation either alone or in conjunction with futures markets. The 1936 Act pro-

50. See id.
scribed manipulation, fraud, and spreading false rumors, in both futures and cash markets.\textsuperscript{56} However, since forward contracts, private contracts for forward sales of a physical commodity, were exempt from the taxing authority of the 1921 Act,\textsuperscript{57} regulation of forward contracts, other than with respect to prohibiting manipulation, was not within the aegis of the Secretary of Agriculture. The anomaly in such a regulatory system was, and still is, that forward contracting appears to be an integral part of the cash market.

The system of regulation established by the 1936 Act divided regulatory responsibilities between the federal government and the exchanges. It is best described as a system of strong exchange self-regulation with weak federal oversight. At that time, the industry was highly structured. Both cash and futures marketing centers were located at terminal markets where common participants held exchange membership. Exchange membership, therefore, was the focal point of the 1936 Act. Membership was viewed as at the perimeter of interests potentially most important to producers, hedgers, and small speculators. Therefore, it was viewed as most in need of regulation. Congress made no attempt to mandate a structure. Instead, it recognized an existing regulatory structure.

The exchanges' primary role under the 1936 Act was to enforce rules against cheating, fraud, manipulation, wash trading, and puts and calls. The exchanges' designations as contract markets could be withheld to insure proper regulation. The role of the federal government apparently was limited to watching exchanges perform these regulatory functions.

Although the 1936 Act favored certain interests, largely derived from The Grain Futures Act, it also recognized the legitimate needs of small speculators. In keeping with the "horse operas" of the time, farmers, widows, and orphans continued to be protected. The purpose of the legislation was to maintain orderly markets against the specter of manipulation and fraud. The 1936 Act continued to pass out "black hats" to those who, in the words of The Grain Futures Act, created sudden or unreasonable fluctuations in futures prices by "speculation, manipulation, or control, which [was] detrimental to the producer or the consumer . . . ."\textsuperscript{58} The

\textsuperscript{57} See notes 29 & 30 supra and accompanying text.
Commodity Exchange Act stated that “[e]xcessive speculation in any commodity under contracts of sale . . . for future delivery . . . causing sudden or unreasonable fluctuations or unwarranted changes in the price of such commodity, is an undue and unnecessary burden on interstate commerce in such commodity.” With emphasis on the malfeasance of large speculators, presumably to the benefit of commercial grain and cotton firms and agricultural producers, perhaps the wonder of such an act is that its anti-manipulative provisions could be successfully enforced against a grain company or an agricultural cooperative association.

The reach of the 1936 Act, however, was still limited. Any unnamed commodity was exempted, whether or not it was traded on an exchange designated for trading in other commodities. For these commodities, there was no federal requirement of segregation of customer funds, the traditional method used by clearing-houses and exchange members to protect themselves and their customers. Entire exchanges, such as the New York Coffee and Sugar Exchange, Inc., Commodity Exchange, Inc. (COMEX), and the New York Cocoa Exchange were unregulated.

Off-exchange futures markets could be made in any of the unregulated commodities. Commodity options in those commodities could be offered to the public with no protection other than the modest safeguards provided by state fraud and breach of contract statutes. Trading through a domestic futures commission merchant in foreign commodity futures markets did not, and still does not, require segregation of United States customers' funds, notwithstanding United States jurisdiction over both the customer and domestic brokerage house involved.

In the technical sense, governmental oversight of commodities not named in the 1936 Act was not totally lacking. The Department of Justice and the Federal Trade Commission were concerned with antitrust problems which emanated from futures markets and attendant cash market activities. Moreover, all forty-


60. For examples of such successful enforcement, see Cargill, Inc. v. Hardin, 452 F.2d 1154 (8th Cir. 1971), cert. denied, 406 U.S. 932 (1972); In re Plains Cotton Coop. Ass'n, COMM. FUT. L. REP. (CCH) Report Letter 53, at 3 (July 29, 1977) (summary of CFTC administrative proceeding).

eight states could exercise control over commodities markets under their own statutes.

Thirty years followed the enactment of the 1936 Act with few major disturbances in the system. Prices in many regulated commodities were flattened by governmental farm policies during much of the period. The exchanges in Memphis and New Orleans, as well as most grain exchanges directly affected by the 1922 Act, passed into history. In 1958, Congress banned futures trading in onions following allegations of manipulation in onion futures. The De Angelis “salad oil” scandal passed.

The late 1960’s and early 1970’s brought changes and problems of new dimensions. In 1968, new commodities, live cattle, pork bellies, and frozen concentrated orange juice, for example, were brought under regulation by amendment to the Commodity Exchange Act. In the same year, Congress adopted another amendment to the 1936 Act requiring exchanges to enforce their own rules. Shortly thereafter, with world conditions favoring unlimited production, the marketplace commenced one of its most noted reactions to market demand since the 1920’s. Farm prices began to rise, boosted by commodity sales to the Soviet Union in 1972. It was the beginning of one of the great “bull” markets of the century.

Traditionally, rising prices enhance commodities market activity. Thus, in the early 1970’s, the commodities investment complex was becoming more attractive. Investors with speculative capital, turning from the ailing securities markets, entered commodities trading. Silver “straddles,” providing favorable tax treatment of investment profits and losses and possibilities for tax deferral, were also becoming popular. Increased capital and attendant activity attracted new people to service the industry. However, many of these new entrepreneurs felt little allegiance to the traditional industry infrastructure, with its exchanges and its philosophy of self-

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62. See note 18 supra and accompanying text.
63. For a discussion of this scandal, see N. MILLER, THE GREAT SALAD OIL SWINDLE (1965).
65. See id.
regulation. Many found exchange membership, with its folkways and rigid traditions, unappealing or unnecessary.

Much of the new “action” was in commodity options, items not offered on any United States exchange. Promising extraordinary profits, a California firm, Goldstein, Samuelson, Inc., began selling options in unregulated commodities. The firm parlayed its initial capital investment of $1000 into a multimillion dollar business; its success, however, was short-lived. Soon after its mercurial ascent to the heights of the financial community, Goldstein, Samuelson’s operation was revealed to be a Ponzi scheme, using new customer premiums to pay off previous customers who had “won.” Customer losses on the firm’s collapse were estimated to be greater than $71 million. There had been no segregation of customer funds. For the urban public, until then generally unaware of the commodities industry, the publicity attending the scandal was a dubious introduction.

There was little statutory authority over firms like Goldstein, Samuelson, except on the theory that naked options, unlike covered options, were actually “securities” subject to securities regulation. Other firms were following Goldstein, Samuelson, and the mainstream industry began to sense an unarticulated public desire to buy options outside the existing governmental and industry regulatory apparatus.

Viewed one way, Goldstein, Samuelson symbolized what was going wrong in the industry. Later, after passage of the 1974 amendments, some exchange heads would “blame” Goldstein, Samuelson for the new system of regulation.

During this period, 1969 to 1973, volume in regulated com-

68. Prior to adoption of the 1974 amendments, trading “puts” and “calls,” “privileges,” and “indemnities”—all forms of options—in commodities listed in the Commodity Exchange Act were prohibited, see 7 U.S.C. § 6c (1970) (amended 1974). Option trading in unlisted commodities was unregulated. The 1974 amendments continued the ban on option trading in the “previously regulated” commodities. The amendments left to the Commodity Futures Trading Commission (CFTC) the decision whether, and if so, under what terms, option trading should be permitted in the newly regulated commodities, see Commodity Futures Trading Commission Act of 1974, Pub. L. No. 93-463, sec. 402, § 4c, 88 Stat. 1389 (codified at 7 U.S.C. § 6c (Supp. V 1975)).


70. See generally SEC v. Commodity Options Int’l, Inc., 553 F.2d 628 (9th Cir. 1977); SEC v. American Commodity Exch., Inc., 546 F.2d 1361 (10th Cir. 1976).
modities nearly doubled. Volume in the unregulated (or as they presented themselves later, the "previously self-regulated") commodities quadrupled. Futures contracts in new commodities such as petroleum were tested, and a ludicrous experiment in diamond futures quickly failed. The Chicago Board of Trade was discussing the possibility of basing a futures market on the Dow Jones Index. Gold futures were considered a possibility.

During this tremendous expansion, the Department of Agriculture's Commodity Exchange Authority could not enforce existing law. Successive Secretaries of Agriculture failed to increase the staff of the Commodity Exchange Authority sufficiently to cope with the growth of the marketplace. In fact, budget restrictions had resulted in personnel cutbacks. The Commodity Exchange Authority's 165 employees were ostensibly regulating a $400 billion industry.

Elsewhere, it was becoming apparent that the industry-wide consent to a schedule of federal implementation of negotiated commissions for nonexchange members and the government's antitrust challenge to the Chicago Board of Trade's fee setting procedures raised questions about the future of exclusive self-regulation by exchanges. What would be the motive for continued exchange membership?

Historically, commodities exchanges have resisted federal regulation. In this period, 1969 to 1973, most exchanges continued to view themselves as champions of self-regulation and free enterprise. At the same time, however, regulated exchanges were beginning to feel the effect of the 1968 amendment to the Commodity Exchange Act requiring them to enforce their own rules; these

72. Id.
73. Id. at 1.
74. See Arenson v. Chicago Mercantile Exch., 520 F.2d 722 (7th Cir. 1975).
75. See United States v. Board of Trade, Inc., [1975-1977 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 20,011 (N.D. Ill. 1974). On June 28, 1974, the parties to this action consented to the entry of a final judgment requiring the institution of fully competitive commission and floor brokerage rates on the Chicago Board of Trade by March 4, 1978. See id. Subsequently, other domestic commodity exchanges were notified by the Department of Justice that all commodity exchanges would be treated alike with respect to the legality of fixed commission and floor brokerage rates and that each exchange should establish fully competitive rates by March 1978. See, e.g., Letter from Thomas Kauper, Assistant Attorney General, Antitrust Division, Department of Justice to Everette B. Harris, President, Chicago Mercantile Exchange (Oct. 3, 1974) (on file at the office of the Hofstra Law Review).
rules had originally been adopted solely as general codes of conduct for dealings between members. Counsel to the exchanges were concerned that customers would strictly apply these codes against the exchange community. Counsel, therefore, advised their clients to pare their rules to a minimum to limit private rights of action. In this new age, honorable motives were running afoot of legal reality.

Again, Congress was aroused by producer unrest about futures markets. Corn and soybean prices were climbing, but Iowa farmers, who viewed delivery on futures markets as an alternative to their normal cash market outlets, could not easily deliver against the futures contracts that they had sold at the Chicago Board of Trade. Changes in the existing government-industry relationship were rumored. Increased federal control over the industry was suggested at hearings before the House Select Small Business Committee in the summer of 1973. Several congressional bills were soon introduced proposing major reform of the existing structure.

The legislative environment was fertile for change. Although motives behind legislation do not always parallel stated reasons, there was abundant justification for change. After citing concerns of a more general nature, the report on the 1974 amendments by the House Committee on Agriculture recited a litany of problems facing the industry. These problems included increased size and diversification, inadequacies of existing governmental regulatory apparatus, and fundamental questions about the concept of exchange self-regulation, especially the effect of the 1968 amendment requiring exchanges to enforce their rules. The report listed nine additional considerations for changing the law. Among them were complaints from both producers and consumers about cash and fu-

80. See id. at 39-48.
81. See id. at 48-49.
tures market price relationships and manipulative practices, a growing number of lawsuits against exchanges arising out of situations in which exchanges had taken emergency actions, confusing state regulations and court decisions, the "mechanical" definition of hedging, and problems with options. Perhaps the most telling was the "[g]eneral agreement among the industry that the present law, as written, was simply inadequate to cope with the needs of the present or the foreseeable future, with new problems and new contracts facing the industry." More simply stated, the industry was "exploding through its regulatory seams." The next step in the evolutionary process was underway.

REDEFINITION OF THE GOVERNMENT-INDUSTRY RELATIONSHIP

Once the legislative process began in the fall of 1973, it moved with surprising speed. Within five months, the House Committee on Agriculture held a hearing on proposed conceptual changes in the law and appointed a special ad hoc subcommittee, which drafted a five-title bill. The committee held another hearing to review the proposed bill and adopted over fifty amendments before reporting a "clean" bill, H.R. 13113. The legislation passed the House by a vote of 281 to 43. The Senate Committee on Agriculture and Forestry immediately strengthened the bill, and the Senate passed it. The conference between the two committees adopted almost all of the Senate's strengthening amendments. Although there were objections to the bill within the Ford administration, it was signed into law.

By any measure, the new law was a massive reform. Most of

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82. See id. at 49.
89. Id. at 30,459-68.
the amendments were major revisions of the long-established relationship between government and the industry. Although the new legislation left intact much of the 1936 Act, it also amended it substantially.

To clarify the confusing status of jurisdiction over commodities trading, the 1974 amendments preempted the states from regulating commodity futures transactions. "Exclusive" federal jurisdiction over futures trading was granted to the CFTC. Commodities could no longer be regulated under securities laws.93 The effect of this jurisdicitional decision has been far-ranging. For example, exchanges have begun to initiate futures markets in such securities as Government National Mortgage Association (GNMA) mortgages and Treasury bills. In addition, the initial regulatory vacuum created by the transition from regulation by the states and, indirectly, the SEC, to regulation by the CFTC, set the stage for the current battle over fraudulent sales of "London" commodity options in the United States. The CFTC had come into being under difficult circumstances94 and immediately had to set priorities regarding its mandated responsibilities. It overlooked some regulatory tasks to deal with others. Commodity options were a case in point. Consequently, these options were unregulated for a time.

The framers of the 1974 amendments envisioned a strong federal regulatory presence. All domestically traded commodities were brought under CFTC regulation.95 In addition, the relationship between exchanges and the federal government was significantly altered. The Commission was given pervasive regulatory power regarding all exchange activities. Among the important powers vested in the CFTC was authority over the establishment and approval

93. See id. § 201(b) (codified at 7 U.S.C. § 2 (Supp. V 1975)).
94. The delay in nominating the five members of the Commission after passage of the Commodity Futures Trading Commission Act of 1974 was attributable to several factors. First, President Nixon had resigned, and President Ford had only been in office approximately two months when he signed the new law. The Commissioners were the first large group of nominees presented in the post-Watergate environment, resulting in more elaborate background checks by the White House than ordinarily would have been undertaken. Also, one suspects that neither the significance of the Act, nor the effect of delay in making the required appointments, was fully recognized by the administration. Special emergency legislation delaying the impact of certain provisions of the 1974 amendments was passed, see Act of April 16, 1975, Pub. L. No. 94-16, §§ 2-4, 89 Stat. 77. However, it did not alter the effective date of the exclusive jurisdiction provisions of the new legislation.
of new contracts,96 and the approval of substantive amendments to all bylaws, rules, and regulations, excluding the day-to-day setting of margin levels.97 The CFTC was empowered to resolve such issues as contract delivery points,98 a sore point to producers regarding the Chicago Board of Trade's corn and soybean contracts, and dual trading.99 The CFTC was made responsible for reviewing the competence and effectiveness of exchange rule enforcement100 and for providing dispute settlement procedures.101

Relationships among the federal government, commodity trading professionals, and customers were altered. All persons dealing with customers—associated persons, commodity trading advisors, and commodity pool operators—were now required to register with the new Commission.102 To offset a suspected industry bias favoring the resolution of customer claims through arbitration, a CFTC-supervised reparations forum was created.103

The federal government's ability to respond to market and enforcement emergencies was substantially strengthened by the new law.104 In addition to the traditional authority of the government to suspend or withdraw designation of an exchange105 and to deny malfeasant access to commodities markets,106 the CFTC was given

authority to seek injunctions to enforce the Commodity Exchange Act and its regulations\textsuperscript{107} and to levy monetary penalties up to $100,000.\textsuperscript{108} The Commission also retained authority to refer criminal violations of the Commodity Exchange Act to the Department of Justice.\textsuperscript{109}

The 1974 amendments replaced regulation by the Secretary of Agriculture with regulation by the CFTC, a five-member, independent regulatory commission similar to the SEC.\textsuperscript{110} The degree of the CFTC's independence from the Secretary of Agriculture was the major seriously disputed difference between the House and Senate versions of the bill. The House version provided that the Secretary or his designee would be a member of the Commission.\textsuperscript{111} The Senate version, which contained no such provision, prevailed.\textsuperscript{112} However, the 1974 amendments mandated a "liaison" between the Commission and the Department of Agriculture.\textsuperscript{113} Together with other language in the new legislation,\textsuperscript{114} this provision appears to have been drafted with an eye toward continuing oversight of the Commission by the House Committee on Agriculture and the Senate Committee on Agriculture, Nutrition, and Forestry.

\begin{itemize}
\item \textsuperscript{110} As a result of experiences with other agencies, Congress structured the 1974 amendments to create a relationship among the Commissioners in which management functions were lodged with the Chairman of the Commission. In effect, the amendments created a "strong Chairman"-"weak Commission" management relationship: The four Commissioners have little control over personnel, budget allocation, and hiring practices, except through input in the selection of division heads, the General Counsel, and the Executive Director. See 7 U.S.C. § 4a (Supp. V 1975).
\item \textsuperscript{111} See H.R. 13113, 93d Cong., 2d Sess., 120 CONG. REC. 10,752 (1974).
\end{itemize}
OTHER DIMENSIONS OF THE REFINED GOVERNMENT-INDUSTRY RELATIONSHIP

The scope of the 1974 amendments, with their ambitious purpose—to provide the first complete overhaul of the Commodity Exchange Act since its inception and to propose a comprehensive regulatory structure to oversee the "volatile and esoteric futures trading complex"—presents many important questions in today's new regulatory environment and commends it as a subject for thoughtful study. The new provisions and their relationships to earlier provisions should be examined. Moreover, the CFTC's vigorous enforcement efforts, coupled with the changing needs and nature of the industry, may test assumptions about the older provisions of the law and their relationship with the new language of the 1974 amendments that, judicially or politically, cannot be sustained in a contemporary environment. One wonders, for example, what might be the reaction of the Commission, not to say that of Congress, in the event the CFTC staff should recommend comprehensive regulatory and surveillance programs for all cash markets. While CFTC authority is present, cash markets today function in a more diffuse state than the strong central cash markets of the 1920's or 1930's when the Commodity Exchange Act was adopted. Therefore, extensive CFTC oversight would be unrealistic.

Elsewhere, the system and concepts of regulation envisioned for domestic markets may prove troublesome, as they have already in some areas, when applied to the traditions, marketing practices, and participants in the newly regulated international commodities. For example, the CFTC might be called upon to face the legal and political difficulties of suing a foreign government for cash or futures market manipulation or of enforcing Commission reporting requirements for foreign traders. Unresolved jurisdictional issues thus remain.

The challenge facing the CFTC to implement the 1974 amendments is substantial. This challenge is magnified where, due to negotiated commission rates and stiffer federal requirements for stronger exchange self-regulation, commercial firms and brokerage

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115. See note 14 supra.
houses may wish to leave the exchanges; this might thereby decrease the utility of the exchange self-regulatory apparatus which operates on its membership, and "tilt" the traditional composition of exchange membership in favor of floor brokers, scalpers, and "day traders." The Commission is presently being tested to marshall sufficient staff and expertise to regulate effectively the industry even with its system of exchange self-regulation. The CFTC will almost certainly require more managerial efficiency and resources if it is confronted with an industry becoming larger and more diffuse.

In part, Congress anticipated this environment and authorized, in Title III of the 1974 amendments, the creation of federally sanctioned industry self-regulatory associations. Public interest, as much as the more direct interest of the industry itself, requires strong central self-regulatory apparatus if self-regulation, the basic tradition of the Commodity Exchange Act, is to work. However, what has yet to be fully explored are the alternatives available to achieve that apparatus in the contemporary industry and their compatibility with existing government and industry institutions.

CONCLUSION

Among the most significant effects of the 1974 amendments may be their implicit recognition of the expanded community of interests involved in today's domestic commodities markets. Certain interests are readily identifiable: domestic and foreign speculators and hedgers, and the registrants and exchanges that serve them. Other interests are as easily identified but not so easily addressed; one such group consists of consumers who feel the impact of the price levels reflected through the market system. The interests of agricultural producers continue to be specially recognized under the 1974 amendments.


It is a diverse community. The interests of its members do not always coincide. Consequently, a uniform approach among members of the community concerning details of CFTC rules and regulations is not always possible. Similarly, individual exchanges and firms do not consistently agree on basic market issues.

Also, despite better efforts on behalf of the industry, the community continues to suffer from its darker side. Over 800 customer reparation claims have been filed with the Commission against registered commodities professionals and firms—primarily against option dealers,121 the community's junior members—testimony to the continuing jekyll-and-hyde personality of some environs of the marketplace. Nonetheless, it remains a community that has a common interest in sound markets that are properly regulated to protect the interests of the marketplace itself, its users, market professionals, agricultural producers, and the public.

Questions about the optimal system to achieve that regulation and the proper division of regulatory responsibility between government and industry are more important now than at any other time in history. In substantial part, this is a result of the evolution of the marketplace.

Only three of the ten grain exchanges brought under regulation by The Grain Futures Act in 1922 are active today. However, federal regulation currently extends to ten exchanges with active trading in over forty different commodities.122 Moreover, by enactment of the 1974 amendments, Congress expanded the community regulated by the federal government to include separate markets in options123 and "leverage" contracts124 previously outside the exchange regulatory structure. Congress also included new requirements for regulation of individuals—associated persons, commodity pool operators, and commodity trading advisors—beyond requirements previously believed to be crucial to regulation of the industry.125 Today, the Commission is studying comments on new market instruments, transferable exchange commodity options on

121. Memorandum from CFTC Reparations Unit to Jack Field, Director of Enforcement (Nov. 14, 1977) (reparations status report).
122. See note 15 supra.
futures contracts and physical commodities, as part of a pilot program\textsuperscript{126} to determine whether options traded in such an environment can adequately serve a useful economic purpose and are not contrary to the public interest.\textsuperscript{127} If such a program proceeds, it would set the stage for the first formal new market instrument on American commodity exchanges since the inception of domestic futures markets. The program is designed to bring under control the troublesome London options market through a unique combination of regulation and the provision of a superior competitive market instrument.

Elsewhere, new futures contracts—on financial instruments, on such exotica as the Dow Jones Index, and on more traditional commodities such as rice—and two new exchanges—the American Stock Exchange and a revitalized version of the New Orleans Cotton Exchange—are seeking entry into the community. At the same time, within the past two years, another exchange, the Pacific Commodities Exchange, and several contracts, on wool for example, have died due to lack of market demand.

Driven by the potential damping effect on futures of (1) new farm legislation providing higher support prices for many domestic farm commodities and (2) a surplus of those same commodities, the complex is accelerating its development of markets in nonagricultural commodities. Undoubtedly, if history provides any guide, some of the new contracts will be successful, while others will not. The marketplace itself is appropriately brutal in its assessment of the utility of a futures contract.

These developments in new instruments and in new commodities may indicate that, here too, the marketplace is on the verge of testing certain assumptions underlying the Commodity Exchange Act. For example, section 2(a) of the Act,\textsuperscript{128} together with its legislative history,\textsuperscript{129} indicates an attempt to draw a distinction between the CFTC's jurisdiction over commodities and that over instruments traditionally regulated as securities. A projection of future needs of financial markets may, however, require development of a more sophisticated accommodation between the securities and commodities communities. A futures contract on the Dow Jones

\textsuperscript{127} Id. at 55,555 (to be codified in 17 C.F.R. § 32.10).
Index or an option on that future is not practically that distinct from a future or option, again on the future, on the underlying "package" of securities that goes to make up the Index. In fact, absent barriers of statutory interpretation, there is no reason why an individual listed security might not be viewed as a "commodity," with appropriate application of commodity trading instruments, principles, and regulations. We have already seen that the jurisdiction of the Commodity Exchange Act provides cash as well as futures market jurisdiction over a commodity. Noteworthy is that the Commission's jurisdiction extends to options on physical commodities.

Political considerations aside, a purist might now be tempted to question congressional placement of jurisdiction over option markets on listed securities. If the principal users of such markets are firms and individuals seeking to hedge price risk or to speculate on it, then a case may be made that such markets are closer to traditional commodities markets than ordinarily assumed.

For the CFTC, the smallest and newest independent regulatory agency in the federal government, however, struggling to overcome initial administrative and political "teething" problems provides ample challenge. For such a period, it would appear that the appropriate watchwords are transition and evolution in the marketplace and its regulatory structure. A major danger would be for government or community institutions to be allowed to gravitate. To paraphrase Henry Ward Beecher, both, like clocks, "must occasionally be cleansed, and wound up, and set to true time."

130. See notes 56 & 116 supra and accompanying text.
132. H. Beecher, Life Thoughts 129 (E. Proctor ed. 1859).